The accounting treatment of leases under US GAAP and IFRS has recently undergone a sweeping change, replacing rules that have been in place for over 30 years. According to some estimates, this accounting change will ultimately bring trillions of dollars of off-balance sheet liabilities into companies' balance sheets.[1] The new standards have the following effective dates:

- Accounting Standards Codification Topic 842 (ASC 842) under US GAAP:
  - Publicly-traded companies and certain other SEC filers: Mandatory for fiscal years (including interim periods within those fiscal years) beginning after December 15, 2018. For calendar-year companies, this means an effective date of January 1, 2019.
  - All other entities: Mandatory for fiscal years (including interim periods within those fiscal years) beginning after December 15, 2020. For calendar-year companies, this means an effective date of January 1, 2021.
  - Early adoption allowed.
- IFRS 16 *Leases*:
  - All entities reporting under IFRS: Mandatory for fiscal years (annual periods) beginning on or after January 1, 2019.
  - Early adoption allowed.

While these standards are not fully converged, in simple terms they will both have the effect of requiring *lessees* to recognize lease liabilities and a corresponding right-of-use (RoU) asset on the balance sheet for all lease agreements:

- US GAAP adopted a dual lessee accounting model: Operating leases (previously an off-balance sheet item) are now recognized on the balance sheet. However, the rent (lease) expense will continue to flow through the income statement. Conversely, finance leases (formerly capital leases) will continue to have a similar treatment as in previous rules. This means that there is no rent expense being recorded; rather amortization (of the RoU) and interest expenses associated with the lease agreement are recognized separately in the income statement.
- IFRS introduced a single lessee accounting model: all the previous operating and capital leases will now be classified as finance leases and capitalized on the balance sheet. In the income statement, rent expense is now bifurcated between depreciation and interest expense. This treatment differs from the US GAAP handling of operating leases.

Accounting for *lessors* saw minimal changes and remains similar to previous rules

The December 31, 2019 data used in U.S. Industry Benchmarking analysis update was retrieved in early January 2020 and reflected a relatively small number of companies that have adopted the new leases accounting rules on their ***annual*** financial statements. To ensure metrics were fully comparable across companies and industries, the authors and other members of the Valuation Digital Solutions team elected to exclude operating leases from the analysis for those companies that have already adopted (e.g., total debt was computed excluding operating lease liabilities).

In the March 31, 2020 update, the Valuation Digital Solutions team assessed the number of companies that reported operating leases in their ***annual*** financial statements under the new rules

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[1] See for example, "IFRS 16 – Effects Analysis" published by the IASB in January 2016. Accessible here: https://www.ifrs.org/-/media/project/leases/ifrs/published-documents/ifrs16-effects-analysis.pdf.

which showed a significant amount of companies reflecting operating leases on their balance sheets. At this time, effective for valuation dates on March 31, 2020 and thereafter, the U.S. Industry Benchmarking analysis includes the impact of operating leases. This affects the computation of the "Latest" and "5-year Average" for the following statistics:

- Unlevered betas
- EV multiples
- Leverage ratios
- Cost of debt
- WACC estimates

For the "Latest" statistics:

- If a company reports operating leases on their balance sheet, operating Leases are included in the computation of total debt, which impacts unlevered betas, leverage ratios, etc. EBITDA adds back rental expense.

For the "5-year Average" statistics:

- For the most recent year (i.e., the latest), the same application as described above.
- For the previous four years (i.e., fiscal year minus one, minus two, minus three, and minus four) we apply the following:
  - If a company reported operating leases on their balance sheet, the actual operating leases are included in the computation of total debt.
  - If a company didn't report operating leases on their balance sheet, each fiscal year adds a proxy of that year's operating leases in the computation of total debt (if applicable).

The proxy operating lease analysis is calculated using the present value of the future minimum lease commitments, based on the methodology of S&P's CreditStats Operating Lease Analytical Model.[2] Lease commitment data for a firm are gathered from the notes to its financial statements. Annual data for the first five years are set forth in the notes. For the remaining lease years, the model assumes the lease payments approximate the minimum payment due in year five. The number of years remaining under the leases is simply the amount "thereafter" divided by the minimum fifth-year payment. The result is rounded to the nearest whole number. For the present value calculation, the discount rate used the issuer's average interest rate (that is, interest expense/average debt outstanding) from the most recent annual statements, which is reflective of the issuer's cost of funds. The resulting present-value figure is added to the reported total debt to account for the impact of operating leases.

[2] S&P Global Credit Portal Ratings Direct: CreditStats Operating Lease Analytical Model. www.standardandpoors.com/ratingsdirect

Source: Cost of Capital Navigator: U.S. Industry Benchmarking Module