Summary of Impact on FHT – Leases (Simplified Overview)

In 2016, the Financial Accounting Standards Board (FASB) issued a new rule (ASU 2016-02, Topic 842) to improve how organizations report leases. This rule requires all leases longer than 12 months—including those previously considered "operating leases"—to be shown on the **balance sheet**.

What This Means

Organizations must now show:

- A **Right-of-Use (ROU) Asset** – the value of the leased item (like office space).
- A **Lease Liability** – the total amount the organization is obligated to pay over the lease term.

This change doesn't affect the lease agreement itself—it's just a new way of recording it in the books.

Example: Office Space Lease

Let's say an organization signs a 3-year lease for office space at $1,000/month.

Under Topic 840 (Old Standard):

- You'd just record $1,000/month as rent expense.
- No asset or liability on the balance sheet.

Under Topic 842 (New Standard):

- You calculate the present value of the total 3-year lease payments (say, $33,000)
- On the balance sheet, you now show:
  - ROU Asset: $33,000
  - Lease Liability: $33,000
- Each month:
  - You reduce the liability as you make payments.
  - You amortize the asset over the lease term.

How This Affects Financial Health Tests (FHTs)

The new lease reporting standard impacts two key ZAP financial health tests:

FHT 2 – Working Capital (Current Assets – Current Liabilities)

- The ROU asset is considered **noncurrent**, but part of the lease liability is **current**.
- This creates an imbalance: there's a current liability without a matching current asset.
- **Result:** Working capital appears lower than before.

FHT 4 – Debt to Total Net Assets

- Lease liabilities now count as debt, increasing the organization's total liabilities.
- **Result:** The debt ratio looks higher, even though the lease terms haven't changed.

Recommendations

To ensure fair evaluation of financial health:

- **FHT 2:** Exclude the current portion of operating lease liabilities from the working capital calculation.
- **FHT 4:** Exclude both current and noncurrent portions of operating lease liabilities from the debt ratio.

This approach is supported by industry practices and regulatory guidance. For example, the SEC issued a letter in 2018 allowing operating leases to be excluded from certain financial requirements.

Summary of Impact on FHT – Leases (Technical Details)

In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-02, *Leases*, (Topic 842) to improve the financial reporting and transparency of leasing activities. The ASU requires an entity to recognize the *rights* and *obligations* resulting from leases as lease assets and lease liabilities on the balance sheet, ***including leases previously recorded and classified as operating leases***. Under the ASU, a lessee should recognize in the balance sheet a right-of-use asset (ROU lease asset) *representing its right to control the use of the underlying asset throughout the lease term* and an associated liability to make lease payments (lease liability). The ASU requires expanded quantitative and qualitative disclosures by both lessees and lessors. This new standard was effective for fiscal years beginning after December 15, 2021.

Basically, the new lease standard reports operating leases on the statement of financial position (balance sheet) instead of solely disclosing the operating leases in the notes to the financial statements. ***The most common example is an office lease with a term > 12 months.*** This is a change in **HOW** the operating leases are recorded and reported even though there is not a change in the actual lease transaction itself. ***It is a book entry.***

The operating leases are reported as ***noncurrent*** ROU assets and as current and noncurrent operating lease liabilities.

EFFECT ON FINANCIAL STATEMENTS AND IMPORTANT RATIOS:

The effect of the new lease accounting and reporting standards directly affects the calculation of two ZAP financial heath tests (FHT).

1. **FHT 2 – Working Capital (Current Assets less Current Liabilities)**
   The ROU lease asset is a noncurrent asset; however, the operating lease liability has a current and a noncurrent portion. This negatively skews the working capital ratio since there is no corresponding current operating lease asset to offset the current operating lease liability.
2. **FHT 4 – Debt to Total Net Assets**
   Recording the operating lease liabilities on the statement of financial position increases the indebtedness of the organization which negatively impacts the debt to total net assets ratio.

RECOMMENDATIONS:

1. **FHT 2 – Working Capital (Current Assets less Current Liabilities)**
   Exclude operating leases (current portion) from the working capital calculation
2. **FHT 4 – Debt to Total Net Assets**
   Exclude operating leases (current and noncurrent portions) from the debt to total net assets ratio

The exclusion of the operating lease liabilities from the calculation of debt covenants is not without support. Knowing for years the pending change in the lease accounting and reporting standards, many organizations worked proactively with their financial institutions to exclude operating leases from the debt covenants. In addition, the Securities and Exchange Commission issued a letter dated October 23, 2018 re: Treatment of Operating Leases under Rule 15c3-1 which basically allows operating lease liabilities to be excluded from the net capital calculation and from the aggregate indebtedness when determining the minimum net capital requirement.