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Lease accounting convergence project: What are the impacts of the new accounting standards?

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Recommended Citation

Jirik, Kevin, "Lease accounting convergence project: What are the impacts of the new accounting standards?" (2014). *Celebrating Scholarship & Creativity Day*. 12.

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Lease Accounting Convergence Project

Introduction

Current US GAAP lease accounting standards, with its four part test, and two forms of accounting for leases has existed since the 1970s. Due to cases such as WorldCom and Enron, where the assigning of other assets to remote bankruptcy entities has caused some of the world's largest bankruptcies and misleading financials. The SEC called for elimination of all off sheet financial arrangements to change the guidelines of financial reporting to better reflect the economic transaction and not distort it. The new proposal has created a Right-of-Use model where new assets and liabilities will be created to represent the value of the lease on the lessee's books. My research explores the repercussions of the accounting proposal and implications the changes can create.

Background

As stated earlier, there are two forms of accounting for leases, operating leases and capital leases which have been the current form of accounting for lease contracts. Operating leases, are similar to rent, where you have an expense every period. Capital leases are more like a loan, you treat the asset like it is owned by the lessee and the lessee would recognize the asset and future loan payments on the balance sheet. So in its simplest form, the new lease proposal is creating all operating leases into capital leases. Several sources estimated that U.S. public companies have \$1.3 trillion in operating lease payments.

Summary of Proposal

The basic premise of the new standard is to take the next step towards convergence of international standards IFRS and US GAAP, creating the transparency SEC called for by adding the new asset and liability on the book, and make it the economic incentive to lease and not setting contracts to work around and remain off the books.

The right of use approach is the new form for accounting for leases. Under the right of use approach, type A and type B leases have been created. Type A leases, primarily deals with equipment and vehicle leases, where it will include two components. An interest expense with an effective interest method of accounting and the lessee will additionally amortize the right of use asset on a straight-line base. Type B leases, deal with assets such as buildings and land otherwise commonly referred to as real estate and will include a single lease expense on a straight-line bases.

The key factor in the proposal, which is focused on this project, is the exploration of valuing the lease contracts to today's dollar. That is present valuing all future lease payments which includes non-cancellable periods and newly added the options to renew or continue a lease where there is "significant economic incentive" to extend the lease.

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Research Question

What financial impacts will the new lease accounting standard have? Specifically to key ratios.

Audience

The relevance at the time of research, is that the project was in its second exposure draft, with upcoming meetings on the topic, and expected final standard to be placed in 2014 and be in effect by 2017. The audience includes analysts of financial statements and those interested in if the impact of the new lease proposal is significant.

Research Process (Existing Research)

Initial research consisted of reviewing several articles, opinions, comment letters, and the proposal itself on the topic. A special thanks to the Equipment Leasing & Finance Association for giving access to the most recent information on the topic and providing the Bloomberg BNA Webinar “Changes in Lease Accounting: Analysis and implications for Your Business”. These resources gave a vast amount of knowledge and consciences of the implications and most recent discussions on how this would have an impact on major companies dealing with leases.

The latest news of the IASB and FASB meetings of March 18-20th dealt with specific types of leases such as sales lease backs, small ticket leases, leases with services and defining terms as “significant economic incentive” to value the ability to exercise options to renew. The boards ultimately could not arrive to conclusive agreement on these and other key agreements, however it was noted progress was made.

Deloitte released an accounting lease survey “Preparing for Implementation” in 2013. This survey consisted of responses from executives and the findings of impacts expected due to the lease proposal. Key findings included that “58 percent expecting impacts on the balance sheet, 53 percent on financial statement disclosures, and 46 percent expecting impacts on their company’s financial ratios” (Deloitte). Among those who expect financial ratio impacts, it was the Debt-to-Equity ratio and the Return on Assets percentage that was perceived to be significantly impacted. This article is what contributed to the research question of how material is the impact to ratios.

The Equipment Leasing & Finance Foundation (ELFF) in December 2011 with the original exposure draft, performed a study titled the “Economic Impacts of the Proposed Changes to Lease Accounting Standards” where it took the top 10 users of operating leases and did an assessment on the impact economic impact. In its appendix B: Methodology statement, it discussed one form of estimating and capitalizing the value of operating leases in the United States. Key assumptions carried on in this research are discussed in personal research process.

Research Process (Personal Research)

The ELFF helped formulate the methodology and major assumptions that had to be made in valuing operating leases. The results are based off a random sample of 50 of the S&P Fortune 500. A random generator formula from excel was used to select the numbers. Financial figures were gathered by the company's 10-K report where by the SEC are required to disclose the future five years of operating leases and a "thereafter" lump sum amount for all payments beyond five years. These 10-K annual reports were pulled from the SEC.Gov 2013 filings database. A key assumption that is made was that short-term leases were included in the first four years of disclosed payments. The fifth year is then the true annual long-term payments. This fifth year was used to divide the thereafter lump sum to estimate the number of future years' worth of payment. The next major assumption is to expect the company is going to continue carrying the same expense amount of operating leases and project that fifth year remains constant for future years of payments. The next challenge is to determine the present value rate. The converting of operating leases into capital leases has been done by credit agencies in the past. Five to six years ago, it was done using a ten percent discount rate which is now viewed as greatly undervaluing the operating leases. In the ELFF's report they conducted there analysis with a six and a half percent discount rate. This research is based on ten to thirty year corporate bonds yielding rates which range from two and half to four percent, and thus conservatively a five percent discount rate was applied. This methodology was then applied to fifty randomly selected companies to come to a value which would add a minimum asset and corresponding liability. It is viewed as a minimum amount due to not taking into consideration of the additional value of options, and continuing the operating lease. The new asset and liability was then added to the company's total assets and total liabilities to compare and calculate the difference in key ratios.

A major company that deals with operating leases is Walgreens. It disclosed in its 2013 annual report that eighty percent of its drugstore locations are leased as well as two of its distribution centers. Secondly, that initial terms are typically 20 to 25 years, followed by additional terms containing renewal options at five-year intervals. The total minimum lease payments for capital leases is \$358 million dollars, when compared to operating leases of \$35,702 million dollars. This case having the disclosure of the five-year intervals for the option renewals allowed for additional testing of the financial figures and key ratios on an individual case. For this individual example, assume the same assumptions and methodology for the total sample set is used. When calculating future year payments, it included an additional ten-years of annual payments when dividing the thereafter lump sum by the fifth year stated. That extends fifteen years in total without the options to renew included. Based on a ten percent to a five percent discount rate, values ranged an additional \$18.2 to \$24.8 billion dollars that would be added to Walgreen's total assets and total liabilities. If you are to assume that the value of the fifth year payments continues for an additional five years due to the option to renew an additional 1.75 to 4 billion dollars on top of the prior values would be added onto the expected fifteen years of payments. Thus totaling 20 to 28.8 billion dollars Walgreens would add to the new lease accounting proposal. This clearly shows how important determining the discount rate and valuing the options to renew could have on financial statements. The impacts this had on the asset turnover changed its value from close to 2.0 down closer to 1.2. Most importantly it changed

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the debt to equity from being reported at 82% to 138% which would greatly change the amount of risk that Walgreens appears to take on to operate.

Key Findings (personal research)

Results based on the sample population, the change included an increase of three percent in total assets and five percent increase in total liabilities. The median impact to debt to equity was a four percent impact and asset turnover with a three percent impact. The reasonable concern this creates with debt to equity ratio is how much risk the corporation appears to take on as an analyst would review the ratio. Secondly, a majority of debt covenants have contingencies that are based on ratios such as debt to equity. This median change to the ratio could breach several debt covenants and create a going concern because all debt in a majority of covenants would come due immediately if not renegotiated. When comparing the asset turnover it would in comparison be viewed to have become weaker for revenue and asset efficiency capabilities of the given corporations. That is due to the revenue being spread over a larger denominator of total assets. When the proposal is implemented companies will be required to have comparative years under SEC standards, yet when comparing to other companies is where a major change could occur. Conclusion to findings show that on a macro level there is a reasonable material impact to financial statements such as income statement, balance sheet, and cash flow statement.

Limitations

The limitations that were encountered during the time of research ending April 23th, 2014 included the ability to review operating lease contracts for the companies and the ability to review how many leases have options attached that would be considered to bear significant economic incentive to continue the lease. The sample size under review could have been greater to more accurately reflect the potential impacts. The major limitation was the undetermined finalized methodology to present value future operating lease payments and its options to renew or continue the lease.

On 24th of April, the day this research concluded, a discount rate was finalized. Based on the article *To The Point* by EY, the boards reached a decision on the discount rate to be used to measure lease assets and liabilities. The Boards decided that the rate the lessor charges the lessee would be defined as the rate implicit in the lease. That both the lessee and lessor would use the rate implicit in the lease when accounting for leases. (Ernst & Young LLP)

Further Research

If this project was to be redone, had more time, or a different path was taken, it would include research on companies expected strategy plan surrounding leases and the new proposal as far as lease terms or switching to purchasing the assets and borrowing from the banks. By change in lease terms it could range from seeing if purchase options were added on more leases, bargain renewals, shortened lease terms, or any other variations. On a micro aspect of lease research would be to review the theory of how to account for all the variety of leases recently being discussed. For example, sales leasebacks, subleasing, leases with service agreements, and the new contract workarounds that would try to be taken to keep a minimum amount of assets and liabilities on the books.

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