LEASE ACCOUNTING CONVERGENCE PROJECT

By Kevin Jirik
OPERATING LEASES

Retail
- **Walgreens**
  (80% of buildings Operating)
- **Walmart**
  (62 distribution facilities)

Transportation
- **Delta Airlines**
  (Airport Terminals, Aircraft, Maintenance Facilities)
- **FedEx**
  (Aircraft, Vehicles, Sorting Facilities, Drop Boxes)

Manufacturing
- **ExxonMobil**
  (Drilling equipment, tankers, service stations, other properties)

Information
- **AT&T**
  (Garages, wireless towers, telephone centers, and retail stores)
TYPES OF LEASES (CURRENTLY)

- Operating Leases
- Capital Leases (4 Part Test)

If any of these are answered yes, then it is a capital lease and is similar to borrowing from a bank (Asset & Liability)
What Financial Impacts Will The New Lease Accounting Standard Have?
AUDIENCE

- Analysts
- User’s of Financial Statements
RIGHT OF USE APPROACH (PROPOSED FORMAT)

- Lessee accounts for the rights and obligations as assets and liabilities

Two Types of leases

- Type A
  - Equipment & Vehicles
  - Interest Expense with Effective Interest Method & Amortization of ROU on straight-line base

- Type B
  - Building & Land
  - Single lease expense on straight-line base

- Present value of all future lease payments including non-cancellable period and options to renew where there is a “significant economic incentive” to extend the lease
BASIC PREMISE OF THE NEW STANDARD

- Convergence
- Transparency
- The off the books Accounting is driving how lease contracts are set up
TIMING

Estimates that U.S. public companies have more than $1.3 trillion in operating lease payments

<table>
<thead>
<tr>
<th>Effective Date</th>
<th>Years Presented in SEC Financial Statements under new rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY 2017</td>
<td>FY 2015, FY 2016, FY 2017</td>
</tr>
<tr>
<td>FY 2018</td>
<td>FY 2016, FY 2017, FY 2018</td>
</tr>
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</table>

Effective date: TBD (not likely before 2017)
- Equipment Leasing & Finance Foundation
  Economic Impacts of the Proposed
  Changes to Lease Accounting Standards
  (2011)

- Roughly 215 billion by top 20 companies
  that use operating leases

- Retail
- Financial Services
- Transportation
- Manufacturing
- Information
- Food Services
- Professional Services
Significant Changes to Financial Statements.

- 58 percent expect impacts on the balance sheet
- 46 percent expect impacts on companies financial ratios

Expected Material Changes in Financial Ratios

- 71 percent (Debt to Equity)
- 52 percent (Return on Asset)
KEY RATIO’S

Debt to Equity Ratio = \( \frac{\text{Total Liabilities}}{\text{Stockholders Equity}} \)

Return on Assets = \( \frac{\text{Net Income}}{\text{Total Assets}} \)

Assets Turnover Ratio = \( \frac{\text{Sales}}{\text{Total Assets}} \)
<table>
<thead>
<tr>
<th>Year</th>
<th>5%</th>
<th>6.50%</th>
<th>10%</th>
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<tbody>
<tr>
<td>2014</td>
<td>24,807</td>
<td>22,502</td>
<td>18,258</td>
</tr>
<tr>
<td>2015</td>
<td>28,817</td>
<td>25,633</td>
<td>20,042</td>
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<tr>
<td>2016</td>
<td>33,599</td>
<td>29,116</td>
<td>21,736</td>
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<tr>
<td>2017</td>
<td></td>
<td></td>
<td>2,389</td>
</tr>
<tr>
<td>2018</td>
<td></td>
<td></td>
<td>2,292</td>
</tr>
<tr>
<td>Later</td>
<td></td>
<td></td>
<td>23,507</td>
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</tbody>
</table>
### Ratios

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Reported</th>
<th>New</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.5% Rate for 20 Years (25,633)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets Turnover Ratio <em>(Sales/Total Assets)</em></td>
<td>2.035</td>
<td>1.182</td>
</tr>
<tr>
<td>Return on Assets <em>(Net Income/Total Assets)</em></td>
<td>6.91%</td>
<td>4.01%</td>
</tr>
<tr>
<td>Debt to Equity Ratio <em>(Total Liabilities/Stockholders Equity)</em></td>
<td>82%</td>
<td>138%</td>
</tr>
</tbody>
</table>
SAMPLE SET

Sample Size 50

Results:
3% increase in total assets
5% increase in Liabilities

Median Changes
4% Debt to Equity Ratio
3% Asset Turnover
.16% Return on Assets
CONCLUSION TO FINDINGS

- Macro level Reasonable Material Impact to Financials
- Impacts
  - Balance Sheet
  - Income Statement
  - Cash Flow Statement
LIMITATIONS

- Methodology finalized for present value of payments
- Sample size
- Ability to review how many leases have options attached that are of “significant economic incentive”
FURTHER RESEARCH

- Companies expected reaction to new proposal
  - New Lease Terms (Purchase options, Bargain Renewal)
  - Shorten Lease terms
  - Lease vs. Buy

- Theory
  - Sales leasebacks
  - Subleasing
  - Leases with service agreements
  - What contract workarounds are possible with new standards?
QUESTIONS?
KEY RESOURCES

- Equipment Leasing & Finance Association
  - Latest News (IASB & FASB Meetings March 18-20th)
  - Comment Letters
- Equipment Leasing & Finance Foundation (December 2011)
  - Economic Impacts of the Proposed Changes to Lease Accounting Standards
- Bloomberg BNA Webinar (June 2013)
  - Changes in Lease Accounting: Analysis and implications for Your Business
- Big 4 Firm Opinions (2013)
  - Deloitte’s Lease accounting survey: Preparing for implementation