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Why the FASB's New Leasing Standard Falls Short of User Needs

Introduction

In this text, I will examine the Financial Accounting Standard Board's new accounting standard on leases that was released in February 2016. The original leasing standard released in 1977 has been the subject of much discussion because of its lack of usefulness for financial statement users and also because of key inconsistencies with the Conceptual Framework of the FASB. Therefore, I will compare the new standard to what is currently in place under U.S. GAAP. I will also introduce case studies of the specific industries, including the oil and gas and airline industries, in order to illustrate the financial statement impacts of the changes. Finally, I will incorporate the viewpoints of public accounting firms, leasing organizations, and a Fortune 500 firm in order to analyze the effectiveness of the new proposal.

The Current FASB Standard on Leasing

Leasing has always been an attractive form of financing and acquiring assets for firms. In a lease, the lessor enters into a contract to give the lessee the right to use property for a specific period of time in exchange for a rental payments over the life of the contract. This is beneficial for a few reasons (Kieso 1292). First, is the cost effective nature of leases. As opposed to a loan, companies generally do not owe a down payment. The second benefit is the flexibility that a leasing agreement offers. Instead of committing to a long-term loan and permanently purchasing an asset, a lessee can construct a flexible agreement that allows the company to cancel the lease

after a certain period of time. This protects the lessee from leasing obsolescence of equipment. The final benefit involves the classification of a lease.

Under current GAAP there are two classifications: capital and operating leases (FASB ASC 840-25-10-1). A capital lease is a lease contract that meets one of four criteria that can essentially be testing for the effective transfer of ownership of an asset. As stated in ASC 840-25-10-1, these include:

1. The lease specifically transfers ownership of the property to the lessor.
2. The lease contains a bargain purchase agreement.
3. The lease term is equal to 75% or more of the estimated economic life of the leased property.
4. The present value of the minimum lease payments equals 90% or more of the fair value of the leased property.

Capital leases are “capitalized”, or recorded on the balance sheet as an asset and a liability at the total present value of the future cash payments. The liability is classified as long-term debt. Since the capital lease effectively transfers ownership of the asset, the lessee records amortization of the leased assets. The lessee also records a cash outflow relating to the interest and principle payments on the lease contract.

Operating leases are leases that do not meet one of the four criteria and thus have not been deemed as an effective transfer of the ownership interests of an asset. They avoid capitalization on the balance sheet and instead are disclosed in the notes to the financial statements as long-term commitments, which is favorable for firms that heavily use operating lease financing. Instead of capitalization, the cash payments required by the lease payments are only recorded as a rental expense on the income statement. There has been on-going discussion

since 1977, when the FASB initially issued Financial Accounting Standards Number 13 (FAS 13) to regulate lease accounting, on whether or not the current accounting treatment for leases provides faithful representation and transparency for the users of financial statements (National Association of Realtors).

Drawbacks of the Current Leasing Standard and a Call for Reform

Many accounting professionals have argued that the treatment of operating leases is “inconsistent with the Conceptual Framework’s definition of an asset and liability” (Spencer, Wright 1). Capital leases are left off the balance sheet under current FASB guidelines because of the idea that ownership of the asset has not been transferred. As Dr. Charlotte Wright and Dr. Angela Spencer explained in an article for the Institute of Petroleum Accounting, the FASB sought to align the accounting for operating leases with the Conceptual Framework when they drafted their 2010 Exposure Draft. Under the Conceptual Framework, the definition of an asset is: “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events” (FASB Concepts Statement No.6, para. 54). A leased contract gives the lessee “the ability to direct and benefit from the use of a specific asset throughout the term of a contract” (Spencer, Wright 3). The operating lease contract gives the lessee effective control over the property, which is valid justification to capitalize it as an asset in accordance with FASB Concepts Statement No. 6. For this reason and because of an ongoing effort to “overhaul off-balance sheet arrangements”, the Securities and Exchange Commission recommended in 2005 that the FASB to revise the leasing standard (Bryan 36).

Subsequent to the recommendation by the SEC, the FASB came out with Exposure Drafts in 2010 and 2013 relating to the new treatment of capital leases. The 2010 Exposure Draft “treated all leases as capital leases” (National Association of Realtors). The 2013 Exposure

Draft, while capitalizing operating leases as a right-of-use asset and a lease liability, deviated from the prior draft in that the distinction between capital and operating leases was maintained. Finally, on February 25, 2016, the FASB issued an Accounting Standards Update for Leases, also known as Topic 842 (FASB).

Comparison of the New Leasing Standard with Previous G.A.A.P.

Similar to the 2013 Exposure Draft, the distinction between finance (capital) leases and operating leases is also retained. Finance leases are leases that effectively transfer ownership of the asset to the lessee and a lease liability is recognized that is classified as debt, almost identical to capital leases in the FASB's ASC 840. Operating leases now require recognition of a right of use asset and a lease liability that are calculated as the present value of the lease payments (FASB ASU 2016-02-Leases). Whether or not to classify an arrangement as a finance lease is determined by meeting one of five criteria; those already used to evaluate capital lease classification as well as a new one stating, "The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term" (FASB ASC 842-10-25-2). If none of the criteria are met, the lease is considered an operating lease (FASB ASC 842-10-25-2). The new leasing is set to go into effect "for fiscal years beginning after December 15, 2018" (FASB).

Pro and Con Arguments for the New Leasing Standard

The question remaining, however, is whether the FASB got it right with the new leasing standard. In the 2010 Exposure Draft, the FASB was planning on having all leases being treated as capital leases currently are. This means that the liability related to operating leases was to be considered long-term debt and key solvency ratios of firms would have been negatively impacted. However after conversations with many different parties, it seems that the FASB

backed off from its original stance. As the Equipment Leasing and Finance Association points out in a February 2016 release, “operating leases are accounted for as the acquisition of [an asset] and the incurrence of a nondebt liability” (ELFA 5). ELFA also points out, this is “positive news for U.S. companies that report their financial statements using U.S. generally accepted accounting principles” (ELFA 4). Did the FASB go far enough to insure that operating leases are accounted for correctly? Did they compromise a bit to provide for an easier transition for firms? I will examine these issues within this paper.

As Mark Vaessen of KPMG IFRG Limited commented in September 2013 regarding the FASB’s Exposure Draft on leases, the new proposals are “a series of compromises- a well-intentioned attempt to accommodate a variety of perspectives” (Vaessen 2). However, this is problematic for a few reasons. First of all, as Vaessen points out the “Boards do not expect the proposals to eliminate adjustments to financial statement amounts by users... [but] seem designed to facilitate an increase in adjustments” (Vaessen 3). To further illustrate this point, consider the methodology used by Moody’s Investor Services, a well-known bond credit rating agency and user of financial statements. In June 2015, Moody’s released an update to their global methodology for financial statement adjustments focusing around operating leases. While this update will “reduce adjusted debt amounts used in Moody’s analysis”, the firm “will continue adjusting debt” by using a present value calculation with firms’ minimum rental commitments for operating leases (Moody’s). In other words, this particular user, and likely other prominent users, plan on continuing to treat operating leases as a debt equivalent. The significance is that treatment of operating lease as long-term debt, will flow into solvency analysis as key ratios will be affected. The standard update will not affect the fact that external users are making financial statement adjustments to fit their own needs.

The other major point that Vaessen makes is that “the proposals remain complex and costly for preparers to implement and apply on an ongoing basis” because of the nature of the “dual model” (Vaessen 3). A standard update similar to the 2010 Exposure Draft would have treated all leases equally as finance leases and would have effectively removed the need for criteria that tests for ownership. While it can certainly be debated whether leases that effectively transfer ownership of an asset should be accounted for the same as leases that only transfer the right to control the asset, there needs to be more consistency across the board of how the new lease information will be used. Under the proposed standard, the added lease liability from operating leases would negatively affect a firm’s liquidity ratios such as “current and quick ratio” but would have no effect on “debt to equity” and perhaps other measures of solvency, according to ELFA (ELFA 8).

Introduction to the Industry Case Study: Methodology of Analyzing Data

In order to illustrate the difference between the original proposal under the 2010 Exposure Draft and the new Accounting Standards Update, I undertook case studies of individual firms within heavily affected industries. The first step in this process was determining which industries will be most heavily impacted by the leasing standard update. To do so, I examined industry data from Compustat’s database relating to firms’ 10-K disclosures of future rental commitments of operating leases. This data was pulled from the 2015 financial statements of nearly 8,000 of the entities from the United States and Canada. I analyzed the magnitude of impact based on the sum of operating lease payments that would be capitalized for each particular industry. Using four digit Standard Industrial Classification codes, I grouped the sample firms into 28 industry groupings (see Exhibit C). Then, I calculated the present value of the operating lease payments to determine the capitalized amount. There were two assumptions

that I made in order to be able to make the calculation. The first assumption I made was an industry wide discount rate of 10% for operating leases, a rate commonly used in other work (see, for example, Dhaliwal et al. 2011 among others). The second assumption I made was regarding the timing of the lease payments. Data for the next five years (2016-2020) was clearly separated by year. However, the data for the lease payments thereafter was lumped into one data figure with varying maturities. For purposes of my study, I assumed that the thereafter portion (after 2020) of the operating leases would be fulfilled within the next 5 years after the first five year period (2021-2025). The payments I used were five equal payments calculated as the total thereafter portion divided by 5. I ran a present value calculation on this annuity stream and made sure to discount it back to 2015. Finally, I added it to my present value calculation of the leases payments for years 2016 through 2020 to arrive at a total estimation of capitalized operating leases. I used a PivotTable to calculate the sum of capitalized operating leases by industry. Figures 1 and 2 illustrate my findings.

Figure 1

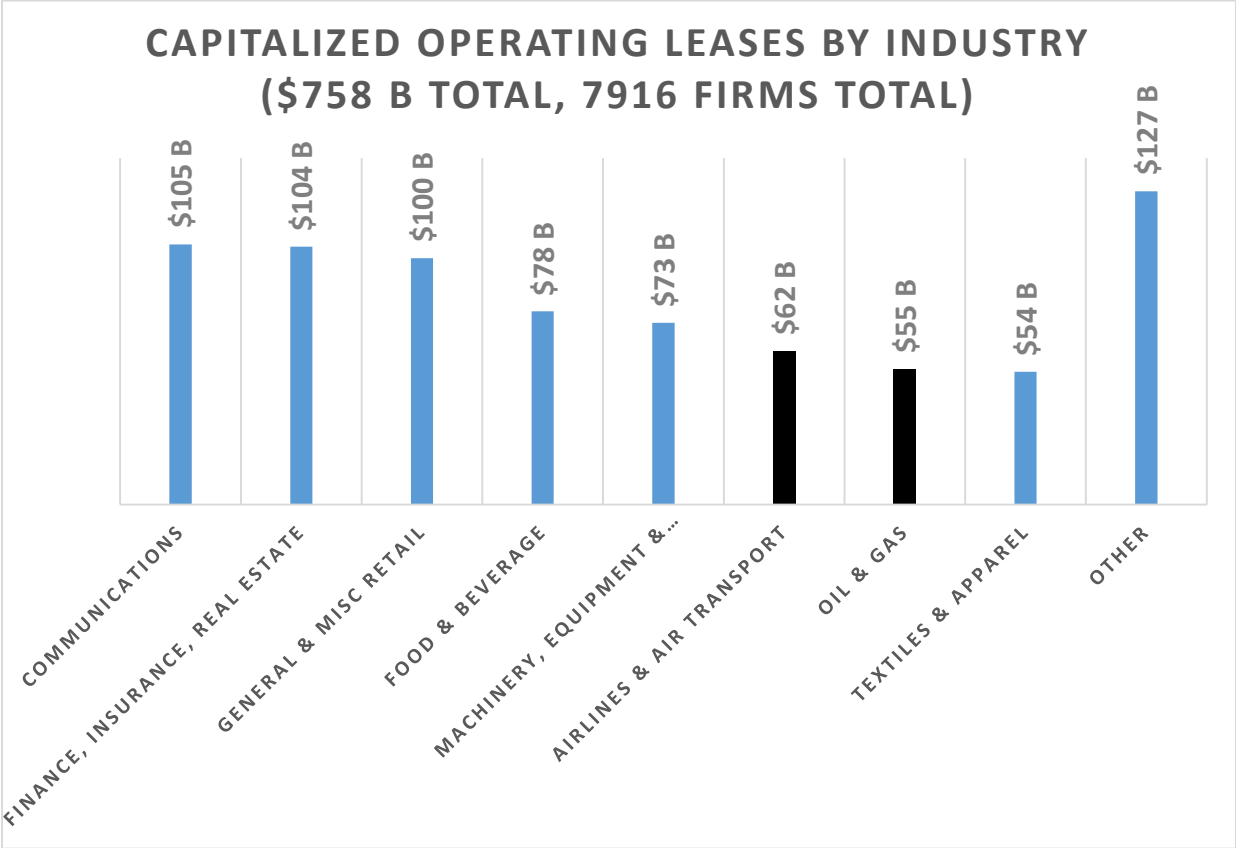
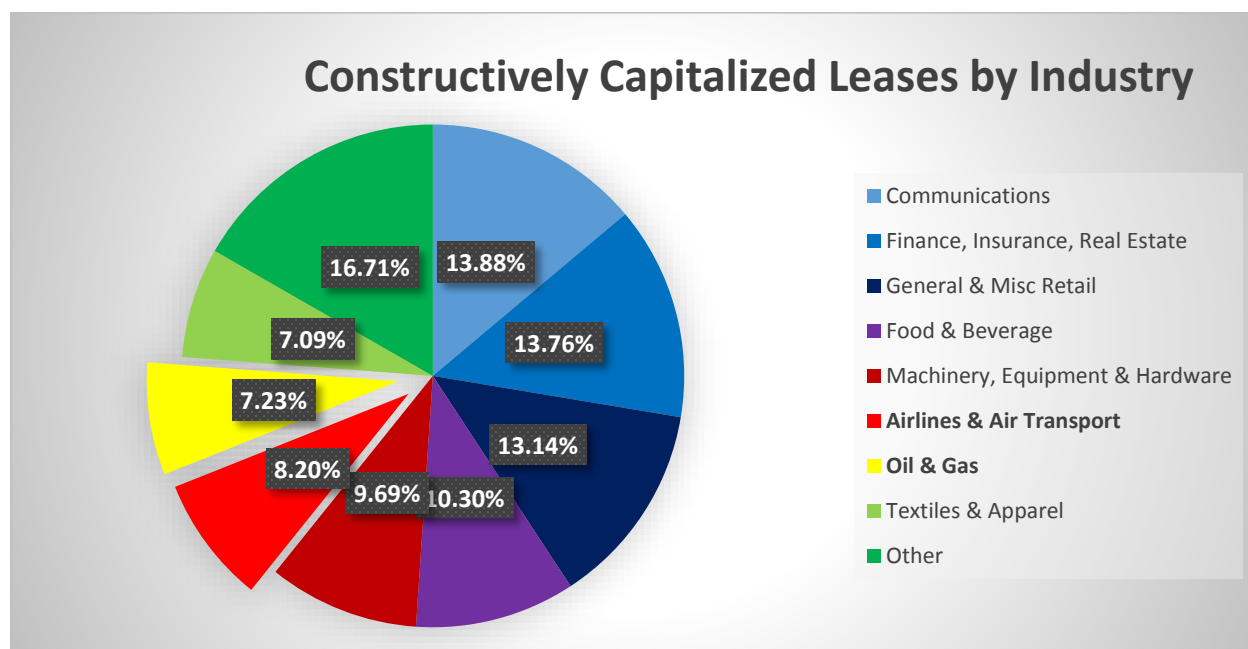


Figure 2



The figures and percentages in the above charts represent the specific industry's portion of the \$758 Billion in operating leases that were constructively capitalized for a sample of nearly 8,000 entities.

Summary of Findings on Industry Capital Lease Data

As illustrated above, the following eight industry sectors that were most heavily impacted by the capitalization of operating leases were:

- Communications
- Finance, Insurance and Real Estate
- General and Miscellaneous Retail
- Food and Beverage
- Machinery, Equipment & Hardware
- Airlines and Air Transportation
- Oil & Gas
- Textiles and Apparel

The total capitalized leases for these eight sectors represented over 83% of the total capitalized leases, \$758 billion in total, for the sample market of 8,000 firms.

Introduction to the Individual Firm Case Studies: Methodology of Analyzing Annual 10-K Reports and Disclosures

Moving along in my analysis, I decided to narrow in on two industry sectors, oil & gas and air transportation, because of the significance of the leasing standard update to these sectors. I will note that although leases relating to the exploration and use of minerals, oil, natural gas, and other non-renewable resources have a scope exemption under the new FASB standard (EY 2), it will significantly impact oil & gas firms because of their high volume of leasing transactions. I looked at the 10-K financial statements of eleven firms, six from the oil & gas industry and five from the airline industry, to determine an amount of capitalized operating leases and to produce pro-forma income statements reflecting the balance sheet impact. I created two sets of pro-forma income statements, one using the proposed standard from the 2010 Exposure Draft and the other using the actual Accounting Standards Update released in February 2016, to compare their relative impacts. I used the 2010 Exposure Draft for my case study because it is better aligned with the needs of financial statement users, primarily in that operating leases are treated as debt. For the oil & gas industry, the six firms that I selected were either fully integrated oil companies or upstream exploration and production companies. The firms selected included: ExxonMobil Corporation, ConocoPhillips Corporation, Chevron Corporation, Anadarko Petroleum Corporation, Devon Energy Corporation, and EOG Resources, Inc. I had originally included Chesapeake Energy Corporation in the case study, however operating leases no longer represent a material avenue of financing for Chesapeake due to “the repurchase of rigs and compressors previously sold under long-term sale-leaseback arrangements” (Chesapeake 98). For the airline industry, I focused on five of the largest American passenger airlines, which included: American

Airlines Group, Inc., Delta Air Lines, Inc., United Continental Holdings, Inc, Southwest Airlines Company, and JetBlue Airways Corporation.

To produce pro-forma income statements, I utilized additional firm-specific information, making the process a bit more involved and complex than my previous calculation of capitalized operating leases using the industry-wide data. Stephen H. Bryan, Steven Lilien, and Dale R. Martin, accounting professors and contributors to *The CPA Journal*, wrote a 2010 article titled “The Financial Statement Effects of Capitalizing Operating Leases” illustrating a case study of Walgreens. This provided the blueprint for the lease capitalization method that I will outline in further detail.

The first step of the process was to pull the 2015 10-K disclosures on operating leases and related rental commitments. Each company is currently required by the FASB to disclose rental commitments for the next five years as well as a thereafter portion of rental commitments due over an undisclosed portion of years. Because of this, a few assumptions were made regarding the timing of the payments. For purposes of my study and in conformity with the Walgreens case study, I decided to “annuitize” the thereafter portion of the leases using the final year of rental commitments outlined (Bryan 37). I will explain this clearly using ExxonMobil’s future operating lease payment disclosures in their 2015 10-K financial statements.

ExxonMobil’s disclosed rental commitments are shown below (in millions of dollars).

2016	1,653
2017	1,003
2018	555
2019	344
2020	265
Thereafter	1,057

I took 2020's operating lease commitments of \$265 million and annuitized them until the thereafter portion of \$1,057 million was fulfilled. The assumption I made was that 2020's rental commitments were the best estimation of later period commitments, although it is likely that the rental commitments were spread over a longer period of time. The resulting estimation of lease payments for the later years is shown below (in millions of dollar).

2021	265
2022	265
2023	265
<u>2024</u>	<u>262</u>
TOTAL	1,057

The second step in my analysis was to find an appropriate borrowing rate to discount the future rental commitments to their present value. Because this information is unavailable or unknown regarding operating leases, I had to impute a value. There were four different methods that I used to estimate the discount rate for operating lease payment. The first was to find a firm's incremental borrowing rate or average interest rate on capital leases. This information was given in the financial statements of ExxonMobil Corporation and Chevron Energy Corporation. The second and most complex method was used when the incremental borrowing rate on capital leases was not given, which generally was the case. I found each firm's disclosed capital lease commitments, which included: payments for the next five years, a thereafter portion, and a present value of the total payments. I used a method similar to my first case study step outlined above to annuitize the 5th year of capital lease payments until the thereafter portion was fulfilled. I finally used a solver to find the discount rate that made my present value calculation for the

capital lease commitments equal to the given net present value that the firm's disclosed. This method was used for Chevron Corporation and the five airline firms. In the first two methods, I made the assumption that this discount rate for capital leases could be used for operating leases. The third method was a calculation of incremental borrowing rate by taking the firm's interest expense divided by average interest-bearing debt (Bryan 37). This method was used when information of the present value of capital lease commitments and borrowing rates on capital leases was unavailable. I did this for the discount rates for Anadarko Petroleum Company and EOG Resources Group. The final method was using the average interest rate for long-term debt. I did this for Devon Energy Corporation as there was not adequate information to use one of the other three methods.

The third step of the process was to use the information calculated in the previous two steps to calculate a present value for the total operating lease commitments. To continue with my illustration of my case study method, we will carry on my previous example of ExxonMobil. Using their average interest rate on capital leases of 9.20% disclosed on their financial statements and the estimated rental payments outlined above (see page 9), I arrived at a net present value of \$3,743 million for ExxonMobil's operating lease commitments. For purposes of the FASB's 2010 Exposure Draft on leases and assuming that the lease standard went into effect in 2015, ExxonMobil would have listed \$3,743 million as a right of use asset relating to plant, property & equipment, \$1,514 million as the current portion of long-term debt (based on the 2016 commitments), and \$2,229 million as the future portion of long-term debt. Under the actual Accounting Standards Update, ExxonMobil would have still recognized \$3,743 million as a right of use asset but the current and future portions of the lease liability would be related to a non-

debt liability. The distinction because such classification affects whether key financial ratios relating to solvency are affected or not.

There is one more important distinction regarding the relative income statement impacts of the 2010 Exposure Draft and the 2016 Accounting Standards Update. Under the 2010 Exposure Draft, leases are all treated similarly to the current definition of a capital lease. This means that interest expense is calculated on the lease liability using the effective interest method while amortization of the asset is done on a straight line basis. Under the Accounting Standards Update provisions for operating leases, “a single lease expense will be recognized, and it will include total lease payments and total initial direct costs over the lease term” (Crowe Horwath 5). This is very similar to the current method for determining operating lease rental expense. The difference is that the lease expense will be calculated on a straight-line basis as the average of total operating lease commitments. There will be a timing difference between the cash payments on leases and the recognized lease expense which would affect the timing of the respective amortizations of the lease liability and right of use asset. However, these amounts will be in sync by the end of the rental contract.

These distinctions in mind, the final step of my analysis was to create two-sets of pro-forma financial statements for each firm. To clarify once more, the first set of pro-forma financial statement is based off of the 2010 Exposure Draft released by the FASB. For this set, the capitalized operating lease liability is divided into a current portion of long-term debt and a long-term portion. The amount of the 2015 rental expense was taken out of selling, general and administrative expenses and allocated interest expense and depreciation expense. To calculate the 2015 interest expense related to capitalized operating leases, I first had to infer the 2015 beginning balance of the lease liability account by taking the sum the 2015 rental expense and

the calculated present value of lease liability and discounting that number back to the end of 2014 using the incremental borrowing rate. Next, I multiplied the beginning balance of the lease liability by the borrowing rate to estimate the interest expense. The excess remaining after the interest expense was deducted from the rental expense represented the depreciation or amortization expense related to the right of use asset. To illustrate this process in further detail, I will continue my previous example of ExxonMobil Corporation. As previously stated, I capitalized \$3,743 million in operating leases representing payments to be made after 2015. To infer the balance of lease liability at the end of 2014, I took the \$3,743 million present value and added it to the rental expense of \$3,973 for 2015 to get a sum of \$7,716 million. Then, I discounted this number back one period to the beginning of 2014 using a discount rate 9.2% (divided the sum by 1.092). This resulted in an opening lease liability balance of \$7,066 million. To find interest expense, I multiplied the \$7,066 million opening balance by the 9.20% rate to arrive at an expense of \$650 million. I calculated the depreciation expense as rental expense minus interest expense to get \$3,323 million ($\$3,973 - 650$). These two numbers affected the firm's overall interest expense and depreciation, depletion, and amortization expense figures, however the firm's overall profitability remains unchanged.

The second set of pro-forma income statements is based off of guidelines set forth by the 2016 Accounting Standards Update for Leases and is an example of the adjustment that is to be made by firm's when it becomes effective in 2018. The capitalized operating lease liability is divided into a current and long-term portion of a non-debt liability. This distinction is important because key solvency ratios relating to long-term debt are not affected under the leasing standard update that will be put in place. For purposes of this case study, I left rental expense relating to operating leases unchanged since the new standard is very similar to the previous standard.

Therefore, no income statement impact results from the new standard. The 2010 Exposure Draft and 2016 Accounting Standard Update account for the right of use asset in the same way. It is calculated as the beginning lease liability balance plus adjustments “for lease incentives received, initial direct costs incurred, and any lease payments made before or at commencement” (Crowe Horwath 5).

Analysis of Individual Firm Case Study Results

The tables below (Figures 3 & 4) illustrate the financial statement impact of capitalizing operating leases on the balance sheet and income statement for both set of pro-forma income statements.

Figure 3: Financial Statement Impact of Operating Leases under the 2010 Exposure Draft (in millions of U.S. dollars)

Company	Amounts Added: Debt Commitments			Reclassification of Rental Expense		
	Current Portion	Long- term	Total	Interest Expense	Depreciation Expense	Total
ExxonMobil	\$ 1,514	\$ 2,229	\$ 3,743	\$ 650	\$ 3,323	\$ 3,973
ConocoPhillips	648	1,287	1,934	82	350	432
Chevron	777	1,822	2,599	296	747	1,043
Anadarko Petroleum	785	1,214	1,999	56	21	77
Devon Energy	67	300	367	21	67	88
EOG	1,231	3,174	4,405	163	66	229
Southwest Airlines	633	3,003	3,636	195	714	909
American Airlines	2,092	9,296	11,389	682	2,118	2,800
Delta Airlines	1,420	6,992	8,411	739	461	1,200
United Airlines	2,367	10,792	13,160	1,231	1,284	2,515
Jet Blue Airlines	162	853	1,015	62	236	298

Figure 4: Balance Sheet Impact of Operating Leases under 2016 Accounting Standards Update (in millions of U.S. dollars)

Company	Amounts Added: Non-Debt Lease Liability		
	Current Portion	Long- term	Total
ExxonMobil	\$ 1,514	\$ 2,229	\$ 3,743
ConocoPhillips	648	1,287	1,934
Chevron	777	1,822	2,599
Anadarko Petroleum	785	1,214	1,999
Devon Energy	67	300	367
EOG	1,231	3,174	4,405
Southwest Airlines	633	3,003	3,636
American Airlines	2,092	9,296	11,389
Delta Airlines	1,420	6,992	8,411
United Airlines	2,367	10,792	13,160
Jet Blue Airlines	162	853	1,015

As shown in Figure 4, the 2016 Accounting Standards Update would capitalize a lease liability, along with a right of use asset; however, the lease liability will technically not be classified as debt liability. There is no significant financial statement impact as rental expense will be accounted for similarly. In contrast, the lease liability would have been classified as debt had the FASB decided to implement the 2010 Exposure Draft as its new policy for U.S. GAAP. The other impact is that the rental expense relating to operating leases would be reclassified. Instead of an equal series of rental payments, two expenses (interest expense and amortization expense relating to the ROU asset) will be recorded. The interest expense would be calculated using the effective interest method. The amortization expense would be calculated on a straight-line method based right of use asset. Because of the limited information available regarding firms' discount rates and opening balances of lease liability and ROU asset, the income

statement effects could in practice be substantially different. Below is a table (Figure 5) of financial ratios regarding liquidity and solvency that would be affected by under both versions of the leasing standard update.

Figure 5: Financial Ratios affected by each Proposed Leasing Standards Update

Financial Ratios for Selected Firms	Liquidity Analysis (would be affected under both the 2010 ED and the 2016 ASU)						Solvency Analysis (only would be affected under the 2010 ED; ratios will not be affected by 2016 ASU)					
	Current Ratio			Net Working Capital Ratio			Interest Coverage			LT Debt to Equity		
Company	2015	Pro-Forma	% Change	2015	Pro-Forma	% Change	2015	Pro-Forma	% Change	2015	Pro-Forma	% Change
XOM	0.79	0.77	-2.73%	(0.03)	(0.04)	-12.09%	71.63	23.86	-66.70%	0.11	0.13	11.19%
ConocoPhillips	0.95	0.89	-6.54%	(0.00)	(0.01)	-134.07%	N/A	N/A	N/A	0.59	0.62	5.49%
Chevron	1.34	1.30	-2.85%	(0.29)	(0.30)	-3.38%	N/A	N/A	N/A	0.22	0.23	5.41%
Anadarko Petroleum	0.95	0.80	-15.81%	(0.00)	(0.02)	-374.05%	N/A	N/A	N/A	1.02	1.10	7.72%
Devon Energy	1.22	1.20	-1.98%	0.02	0.02	-10.24%	N/A	N/A	N/A	1.10	1.13	2.47%
EOG	1.42	0.85	-40.35%	0.03	(0.01)	-150.91%	N/A	N/A	N/A	0.51	0.76	47.71%
Southwest Airlines	0.54	0.50	-7.87%	(0.16)	(0.16)	-1.41%	34.02	13.64	-59.89%	0.35	0.75	118.18%
American Airlines	0.73	0.64	-13.33%	(0.07)	(0.10)	-27.75%	7.05	4.41	-37.47%	3.25	4.90	50.72%
Delta Airlines	0.52	0.48	-7.49%	(0.16)	(0.16)	-0.80%	16.22	7.00	-56.84%	0.62	1.27	103.33%
United Airlines	0.63	0.53	-16.02%	(0.11)	(0.13)	-14.69%	7.72	3.37	-56.39%	1.16	2.36	103.77%
Jet Blue Airlines	0.60	0.56	-6.64%	(0.10)	(0.11)	-5.58%	9.50	6.71	-29.35%	0.43	0.70	61.14%

*Some interest coverage ratios are denoted with “N/A” due to a firm’s negative 2015 EBIT figure

The main concept I am hoping to illustrate is that the changes proposed under the 2010 Exposure Draft would have further reaching consequences for analysis of a firm’s solvency and other key financial figures that the 2016 Accounting Standards Update will not have. As Figure 5

shows, under the 2010 Exposure Draft, firm's long-term debt-to-equity ratio and interest coverage ratio are significantly impacted. For example, Southwest Airlines' interest coverage ratio would decrease by nearly 60 percent and their debt-to-equity ratio would increase by around 119 percent. These represent significant jumps. Under the 2016 ASU, neither of these ratios would be impacted. However, the new ASU will impact the liquidity ratios of firms. If the changes had been effective for the 2015 financial statements, Anadarko Petroleum's net working capital ratio would have decreased about 374 percent, a staggering amount. Their current ratio would have dropped by 16 percent. These are changes that will likely impact some investors in the short-term when the new ASU becomes effective in 2018.

Impact of Leasing Standard Changes on Financial Statement Users

A crucial point that should be made is that, to our knowledge, the key users of financial statements, such as large financial institutions lending capital or making investment decisions, already make adjustments to the financial statements of these firms based on operating lease data. For these users, there will be no need to communicate the reasons why amounts relating to a right of use asset or a lease liability will be reflected on the balance sheet. The analysis of these institutions already reveals a fairly more complete financial picture than what firms' balance sheets are currently presenting. The issue lies in the fact that even after the new ASU is released, the presentation of operating leases on the balance sheet and income statement will remain inconsistent with many financial statement user needs. As Mark Vaessen of KPMG argues, "The Boards have a responsibility to evaluate the financial reporting preferences of their various constituencies (including users) and determine whether they can be reconciled to the Boards' respective conceptual frameworks" (Vaessen 3). He goes on to say that any new proposal "should result in fewer adjustments to financial statement amounts" and users' "need for

supplemental information” as compared to what is currently U.S. GAAP (Vaessen 4). It should be noted that his comments are relating to the 2013 Exposure Draft and that this is the perspective of only one firm. However, a compelling argument is made.

The Equipment Leasing and Financing Association takes an opposing stance on this issue. In a release addressing the February 2016 leasing standards update, the organization argues that with operating leases, entities “do not own the physical asset and the lease obligation is not debt” (ELFA 2). While it is a fact that ownership of an asset will be retained by the lessor in an operating lease, it remains to be seen if most users of the financial statements will shift their attitudes and also consider operating leases as a non-debt commitment. There is no way to know for sure, however, I believe that users will continue to view operating leases as a financing transaction rather than an operational expenditure. The reason is that while operating lease contracts are fairly flexible, they are long-term commitments of fixed future cash outflows. Operational expenditures can be more easily reduced or adjusted. ELFA, while very knowledgeable about nuances of the leasing standard and its potential impact on firms, does have its own financial interests to protect. It is a trade association representing firms that offering equipment financing services. It is to their benefit that firms continue to view leasing as a superior way of financing in comparison to taking out a loan to purchase property and equipment outright. ELFA even acknowledges this in their release, stating, “The net result is that leasing, compared to borrowing to buy, will show a better Return on Assets (ROA), which can be the basis for bonus compensation” (ELFA 4). It is not in the best interest of this organization for all leases to be treated as finance leases because this would eliminate many of the incentives firms have to lease property in preference to purchasing it.

Interview with Mark Davis of the ExxonMobil Accounting Policy Team

After studying the perspectives of various financial statement users and entities that lease equipment, I thought it would also be appropriate to also understand how corporate entities are thinking regarding the new leasing standard update. I was fortunate enough to get connected with one of ExxonMobil Corporation's accounting policy staff members to conduct a phone interview regarding his thoughts on the leasing standard update in April. I spoke with Mark Davis, an Accounting Policy manager in ExxonMobil Corporation's Upstream division, about what the standard update would mean for his firm and the industry. His team works specifically with leases and other obligations and sees to the integrity of data and makes sure that the guidelines set forth by the Corporate Accounting Policy group are followed. He indicated to me that ExxonMobil was still early in the planning process on how to approach the new leasing standard. The firm was still unsure as to how material the impact would be on them from an account and disclosure standpoint and what accounting system changes would need to be made. However, he noted that there were no concerns on the corporation's end about the capitalized operating leases affecting debt covenants with institutions that had lent them capital. He pointed out that those institutions already use the 10-K disclosures to find items such as operating leases and use these "debt equivalents" in their calculations of creditworthiness. In other words, under the firm's perspective the lease standards update will have a negligible effect on current debt covenants.

One potential concern he explained was that in short-term it could possibly affect investors who are unfamiliar with 10-K disclosures and invest based solely on the financial statements. As part of my case study on the oil & gas industry, I projected of how many dollars' worth of liabilities would be capitalized for ExxonMobil if the new leasing standard had been put into place today. I estimated \$3.74 billion in additional capitalized lease liability, with \$1.5

billion representing the current maturity. From an investor's perspective, this is a substantial jump. ExxonMobil's working capital ratio would drop 12.09%. However, Davis was confident that this potential issue could be remediated with the firm's planned efforts to educate the investor community.

Another intriguing note from our conversation was some insight into the ongoing conversations that the FASB has had with ExxonMobil's accounting policy staff and management. As Davis explained to me, the FASB was considering making each publicly traded company capitalize the entire portion of every operating lease contract in which they were the primary operator. Let's illustrate this example in further detail. Firm A enters into a contract with the Lessor to lease equipment and is considered the operator of the right of use asset and is responsible for making the rental payments. The total sum of the discounted rental commitments equal \$5 million over the life of the contract. However, Firm A has leased this equipment as part of a joint venture with Firm B. Firm A bills Firm B for their respective portion of using the asset, which equals 40% usage. What the FASB had dialogue with ExxonMobil and other firms about was having the firm who signed the contract as the "operator" capitalize the full amount of the contract. So in the preceding example, Firm A would recognize the full amount of the contract, a right of use asset, and a lease liability equaling \$5 million. As one might imagine, this idea was met with a lot of concern from firms. Firm A, while being the operator of the equipment and the entity who entered into the contract, is not realizing the full amount of economic benefits of the asset nor controlling all of its use. Still using the above example, it would make more sense for Firm A to capitalize \$3 million related to operating lease commitments while Firm B capitalizes \$2 million. This is precisely what the FASB decided to do with the new leasing standard.

Key Takeaways and Conclusion

Another interesting detail that I found in my research was that despite the FASB and IASB's joint efforts on the lease accounting project, they came to different conclusions on how to best account for leases under their respective standards. According to ELFA, "the IASB has adopted a one-lease model for all leases in which operating leases are treated as financing leases" which means that "the lease liability is classified as debt" (ELFA 4). There has been an ongoing effort in the practice to align IASB and FASB standards as much as possible, keeping new FASB standards consistent with the Conceptual Framework. The alignment would allow financial statements to be comparable on a global basis. One has to think that the difference in opinion between both standard-setting bodies will result in this leasing standard being revisited at a future time and perhaps will result in another standards update. On top of that, one of the major goals that the FASB had in mind when the leasing standards project was announced was the idea of aligning the lessor and lessee accounting models for operating leases. However, the result was the accounting treatment for the lessor model for operating leases viewing the transaction as financing while the lessee model views operating leases as an operational expense. Mark Vaessen of KPMG notes in a letter, "Irrespective of whether one believes that a given lease is or is not a financing transaction, we can see no basis for the lessee and lessor models taking different positions on this point" (Vaessen 3). The fact is that the new ASU issued by the FASB will not achieve the level of consistency and cohesion that was intended when the project was originally announced.

One of the biggest criticisms of the new standards update will be that the significant costs that will be undertaken for firms to be able to account for leases correctly. As Mark Vaessen points out, "the proposals remain complex and costly for preparers to implement and apply on an

ongoing basis” (Vaessen 3). The new standards will require even more disclosures on leases than before. As with any accounting standards updates, firms will have to spend time and resources on adjusting their accounting guidelines and systems to be able to account for the changes correctly. It seems as if the FASB was merely content with getting the operating leases reported on the balance sheet as a liability rather than going to full measures to ensure that the new changes were robust. Vaessen also notes this saying “the Boards should aim for a high quality accounting standard, not settle for the least bad compromise” (Vaessen 7). I agree with this viewpoint. It is quite inefficient to have thousands of companies reform accounting systems and guidelines, and perhaps expend a substantial amount of economic resources, for a standard that still will fail to meet financial statement user needs and that remains inconsistent.

A significant takeaway of this project was learning how adversarial our process of accounting standard reform is. There are multiple organizations such as corporations, public accounting firms, financial statement users, and others, with their own interests in mind first, that have open dialogue with the FASB about standards proposals. The FASB then has to decide how to effectively meet the needs of each group while keeping proposals consistent with the Conceptual Framework. It is an unenviable task and the reason why each accounting standard takes some time to develop. In conclusion, I maintain my stance that the FASB’s standard, while an improvement over the 1977 standard, still does not effectively meet financial statement user needs. Eventually, I anticipate the issue lease accounting will be revisited once more and another update will be made.

Appendix

Exhibit A: Sample Disclosure of Operating Lease Commitments from ExxonMobil

Corporation's 2015 Annual 10-K Report

	Lease Payments Under Minimum Commitments		
	Drilling Rigs and Related Equipment	Other	Total
	<i>(millions of dollars)</i>		
2016	827	826	1,653
2017	408	595	1,003
2018	134	421	555
2019	89	255	344
2020	77	188	265
2021 and beyond	86	971	1,057
Total	1,621	3,256	4,877

Net rental cost under both cancelable and noncancelable operating leases incurred during 2015, 2014 and 2013 were as follows:

Exhibit B: Capitalized Operating Leases as a Proportion of Total Assets

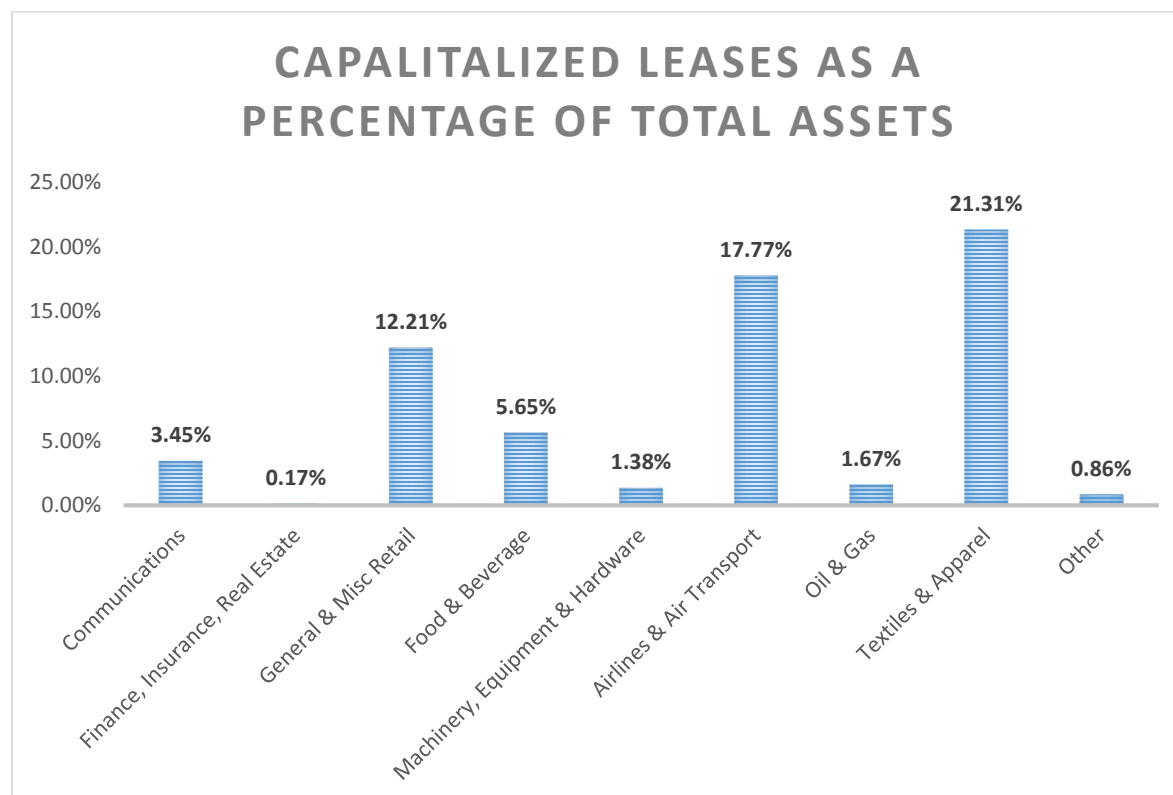


Exhibit C: Industry Groupings Detailed

Industry	SIC Code(s)
Communications	4812, 4813, 4832, 4833, 4841, 4888
Finance, Insurance, Real Estate	6020, 6035, 6036, 6099, 6111, 6141, 6153, 6159, 6162, 6163, 6172, 6199, 6200, 6211, 6282, 6311, 6321, 6324, 6331, 6351, 6361, 6411, 6500, 6510, 6512, 6519, 6531, 6532, 6552, 6722, 6726, 6792, 6794, 6795, 6797, 6798, 6799
General & Misc Retail	5311, 5331, 5399, 5900, 5912, 5940, 5944, 5945, 5961, 5990
Food & Beverage	2000, 2011, 2013, 2015, 2020, 2030, 2033, 2040, 2050, 2052, 2060, 2070, 2080, 2082, 2084, 2085, 2086, 2090, 2092, 5400, 5411, 5412, 5810, 5812,
Machinery, Equipment & Hardware	3510, 3523, 3530, 3531, 3532, 3533, 3537, 3540, 3541, 3550, 3555, 3559, 3560, 3561, 3562, 3564, 3567, 3569, 3570, 3571, 3572, 3576, 3577, 3578, 3579, 3580, 3585, 3589, 3600, 3612, 3613, 3620, 3621, 3630, 3634, 3640, 3651, 3652, 3661, 3663, 3669, 3670, 3672, 3674, 3677, 3678, 3679, 3690, 3695, 3711, 3713, 3714, 3715, 3716, 3721, 3724, 3728, 3730, 3743, 3751, 3760, 3790, 3812, 3821, 3822, 3823, 3824, 3825, 3826, 3827, 3829, 3841, 3842, 3843, 3844, 3845, 3851, 3861, 3873, 3942, 3944, 3949, 3950, 3990, 5200, 5211
Airlines & Air Transport	4512, 4513, 4522, 4581
Oil & Gas	1311, 1381, 1382, 1891, 2911, 2950, 2990
Textiles & Apparel	2200, 2211, 2221, 2250, 2273, 2300, 2320, 2330, 2340, 3021, 3100, 3140, 5600, 5621, 5651, 5661
Chemicals & Synthetics	2800, 2810, 2820, 2821, 2840, 2842, 2844, 2851, 2860, 2870, 2890, 2891, 3011, 3050, 3060, 3080, 3081, 3086, 3089
Pharmaceutics	2800, 2833, 2834, 2835, 2836
Furniture & Home Decor	2510, 2511, 2520, 2522, 2531, 2590, 5700, 5712, 5731, 5734, 5735
Automotive	5500, 5531, 7500, 7510
Transportation & Public Transit	4011, 4100, 4210, 4213, 4400, 4412,
Wholesale Goods	5000, 5010, 5013, 5030, 5031, 5040, 5045, 5047, 5051, 5063, 5065, 5070, 5072, 5080, 5082, 5084, 5090, 5093, 5099, 5110, 5122, 5130, 5140, 5141, 5150, 5160, 5171, 5172, 5180, 5190
Lumber, Wood & Paper	2400, 2421, 2430, 2451, 2452, 2611, 2621, 2631, 2650, 2670, 2711, 2721, 2731, 2741, 2750, 2761, 2780, 2790
Gas, Power, Utilities	4911, 4922, 4923, 4924, 4931, 4932, 4941
Mining	1000, 1040, 1044, 1090, 1220, 1221, 1400

Clay, Stone, Glass, Concrete, Metal	3220, 3221, 3231, 3241, 3270, 3272, 3281, 3290, 3310, 3312, 3317, 3330, 3350
Transport & Storage Services	4610, 4700, 4731,
Construction	1531, 1540, 1600, 1623, 1700, 1731
Tobacco	2111
Agriculture, Forestry, Fishing	100, 200, 700
Entertainment & Recreation	7812, 7819, 7830, 7841, 7900, 7948, 7990, 7996, 7997
Health & Educational Services	8000, 8011, 8050, 8051, 8060, 8062, 8071, 8082, 8090, 8093, 8200, 8700
Hotels	7000, 7011
Misc Services	8700, 8711, 8721, 8731, 8734, 8741, 8742, 8744
Personal & Business Services	7300, 7310, 7311, 7320, 7323, 7330, 7340, 7350, 7359, 7361, 7363, 7370, 7371, 7372, 7373, 7374, 7380, 7381, 7389, 8300, 8351, 8742
Public Administration	9995, 9997

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