



A New Way to Hide Debt...Again

“Non-Commenced leases” are the new version of operating leases, an accounting loophole that companies used to [hide debt off-balance sheet](#) prior to Accounting Standards Update (ASU) [2016-02](#). This new accounting trick is another in the long history of companies exploiting loopholes in Generally Accepted Accounting Principles (GAAP) to [manage earnings](#) and make it more difficult for investors to understand the true profitability of a firm.

Our Analyst team identified 13 companies exploiting the non-commenced lease loophole in calendar 1Q21. We feature some of the most egregious offenders in this report, including Cytokinetics (CYTK), Yum China (YUMC), Roku (ROKU), eMagin Corporation (EMAN), Twitter (TWTR), Knowles Corp (KN), SunPower Corp (SPWR) and Cheniere Energy (LNG).

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What’s the Issue? – Non-Commenced Leases Help Firm’s Understate Debt

Under ASU 2016-02, operating leases are recorded on the balance sheet when the following has occurred:

1. A contract is signed, and payments have begun – **the contract date**
2. The company receives the leased asset and begins using it – **the commencement date**

The loophole emerges when there is a lag between the contract date and the commencement date, in which a company signs a contract for a lease and begins making payments, but is not yet using the leased asset. In these cases, the lease is considered “non-commenced.” Under current rules, companies do not have to record “non-commenced” leases on their balance sheet.

Figure 1 illustrates how Twitter removes \$447 million in “leases not yet commenced” in 1Q21, which is 41% of the firm’s reported total operating lease liabilities and 7% of reported debt. When we include these non-commenced leases, and [apply a standardized discount rate](#), Twitter’s true operating lease liability as of March 31, 2021 is \$1.4 billion, or 29% higher than reported. [Total debt](#), which includes all the lease liabilities, is 5% higher than reported debt.

Figure 1: Twitter’s Non-Commenced Leases 1Q21 10-Q

Note 6. Operating Leases
The Company has operating leases primarily for office space and data center facilities. The Company subleases certain leased office space to third parties when it determines there is excess leased capacity. Operating lease right-of-use assets obtained in exchange for operating lease obligations were \$123.5 million and \$13.3 million in the three months ended March 31, 2021 and 2020, respectively.
Future lease payments under operating leases and sublease income as of March 31, 2021 were as follows (in thousands):

Year Ending December 31,	Operating Leases	Sublease Income
Remainder of 2021	\$ 176,618	\$ (6,672)
2022	262,094	(1,348)
2023	190,225	-
2024	190,388	-
2025	186,104	-
Thereafter	672,611	-
Total future lease payments (receipts)	1,678,040	\$ (8,020)
Less: leases not yet commenced	(447,118)	
Less: imputed interest	(152,114)	
Total operating lease liabilities	\$ 1,078,808	
Reconciliation of operating lease liabilities as shown in the consolidated balance sheets		
Operating lease liabilities, short-term	\$ 179,051	
Operating lease liabilities, long-term	899,757	
Total operating lease liabilities	\$ 1,078,808	

There were no other material changes in the Company’s operating leases in the three months ended March 31, 2021, as compared to the disclosure in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2020.

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41% of reported operating lease liabilities

Sources: New Constructs, LLC and company filings



As shown in Figure 1, non-commenced leases are often disclosed in the yearly lease payments table. They can also be disclosed only in a separate footnote, but in either instance, these lease liabilities do not appear on balance sheets. Even when non-commenced leases are disclosed in the yearly payments table, they're often removed from a company's calculation of the present value of future minimum lease payments, thereby understating the future payments required.

The Solution – Technology to Find and Collect Non-Commenced Leases

Leveraging our Robo-Analyst technology, we have always included the effects of operating leases in our models, even prior to ASU 2016-02, and will continue to do so going forward. We provide details on how operating leases impact our models in general in [The Impacts of Operating Leases Moving to the Balance Sheet](#).

To ensure companies are not able to hide future liabilities off-balance sheet, we include all non-commenced leases in our calculation of the present value of operating leases. This treatment ensures our calculation of [invested capital](#), the denominator in our return on invested capital (ROIC) calculation, encompasses all capital invested in a business, not just what is reported on the balance sheet.

Beyond operating leases, we identify and fix accounting loopholes by [making 30+ adjustments](#) to provide clients [more reliable](#) & [proprietary](#) fundamental data and research, as proven in [The Journal of Financial Economics](#).

The Impact – Material Change in Future Lease Payments and Debt

FASB's narrowing of the loophole that allowed companies to hide trillions of dollars in capital off the balance sheet was a good first step. However, non-commenced leases present a new loophole that has a similar impact.

Figure 2 shows eight firms, Cytokinetics (CYTK), Yum China (YUMC), Roku (ROKU), eMagin Corporation (EMAN), Twitter (TWTR), Knowles Corp (KN), SunPower Corp (SPWR) and Cheniere Energy (LNG) our analyst team flagged with large non-commenced leases. By excluding these non-commenced leases from the balance sheet, these firms materially understate their reported operating lease liabilities and debt. See Figure 2.

Figure 2: Non-Commenced Leases Result in Understated Lease Liabilities & Debt – As of Calendar 1Q21

Rank	Company	Ticker	Non-commenced leases (\$mm)	Operating Leases Understatement	Debt Understatement
1	Cytokinetics	CYTK	\$218*	46%	25%
2	Yum China Holdings	YUMC	\$164	8%	8%
3	Roku, Inc.	ROKU	\$42	10%	8%
4	eMagin Corporation	EMAN	\$5	94%	5%
5	Twitter	TWTR	\$447	22%	5%
6	Knowles Corp	KN	\$5	6%	4%
7	SunPower Corporation	SPWR	\$25	31%	3%
8	Cheniere Energy Inc	LNG	\$1,100	38%	2%

Sources: New Constructs, LLC and company filings

*Commenced on March 31, 2021. Details on CYTK's operating leases below.

Below, we provide specific examples of the ways companies use non-commenced leases to understate reported operating lease liabilities and debt.

Cytokinetics (CYTK) – Failure to Read Footnotes Leaves Investors in the Dark

In its 2020 10-K, Cytokinetics reported \$3 million in operating lease liabilities. However, in a paragraph above its yearly lease payments table on [page 106](#) the firm disclosed \$218 million in undisclosed lease payments related to a non-commenced operating lease for laboratory space in San Francisco (the "Oyster Point Lease"). At the time, the firm expected to commence the lease in September 2021.

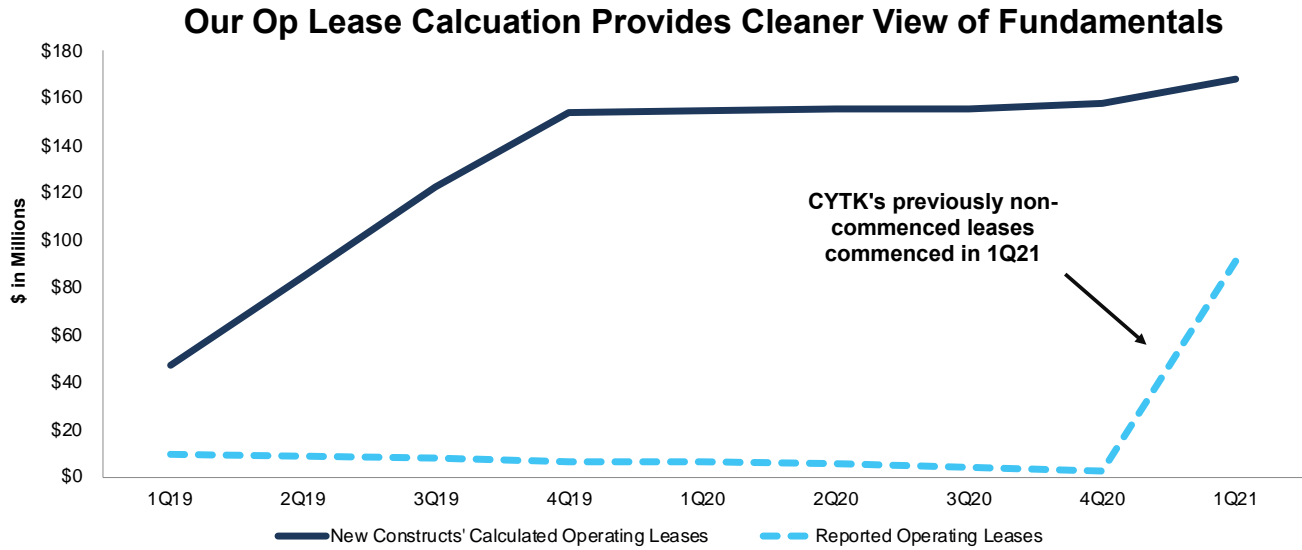
In 1Q21, Cytokinetics' reported operating lease liabilities increased nearly 3200% quarter-over-quarter to \$91 million after the Oyster Point Lease commenced on March 31, 2021. Investors not aware of, or not accounting for, this non-commenced lease would likely be alarmed at the significant jump in operating lease liabilities.

However, our calculation of operating lease liability, which accounts for these non-commenced leases, increased just 6% quarter-over-quarter and provides a much more consistent and accurate representation of the firm's



operating lease liabilities. See Figure 3. After all adjustments to calculate total debt, Cytokinetics' reported debt is understated by 25% at the end of 1Q21.

Figure 3: Cytokinetics' Reported Op Lease Liability Soars When Non-Commenced Lease Commenced



Sources: New Constructs, LLC and company filings

Our calculated operating lease liability remains higher than Cytokinetics' reported liability, even in 1Q21, due to differences in the operating lease discount rate used to calculate the liability. Cytokinetics uses an abnormally high 9% discount rate, which lowers the present value of reported leases. We use a standardized discount rate of 4.5% across all companies under coverage to ensure comparability and remove management discretion in calculating operating lease liabilities. Get more details on how operating lease discount rates can mislead investors [here](#).

eMagin Corporation (EMAN) – Understated Operating Lease Liability

eMagin Corporation's reported operating lease liability of just \$37,000 understates its true lease liability by 94%. On [page 21 of its 1Q21 10-Q](#), below the yearly payments table, eMagin discloses that this reported lease value excludes \$4.9 million in non-commenced leases related to the expansion space of its NY lease. See Figure 4. When we calculate the present value of the firm's true operating lease liability, we find it is much larger at \$710,000. In total, eMagin's use of non-commenced leases allows it to understate its debt by 5%.



Figure 4: eMagin’s Non-Commenced Leases Are 136x Reported Lease Liability – Through 1Q21

Future annual minimum lease payments and finance lease commitments as of March 31, 2021 were as follows (in thousands):

	Operating Leases	Finance Leases
2021	\$ 37	\$ 773
2022	-	1,019
2023	-	1,011
2024	-	1,011
2025	-	1,011
Thereafter	-	18,392
Total undiscounted future minimum lease payments	37	23,217
Less imputed interest	(1)	(10,456)
Lease liability	\$ 36	\$ 12,761

(1) Total future lease payments exclude approximately \$4.9 million of lease payments related to the Expansion Space portion of the NY Lease that was signed but has not yet commenced as of March 31, 2021.

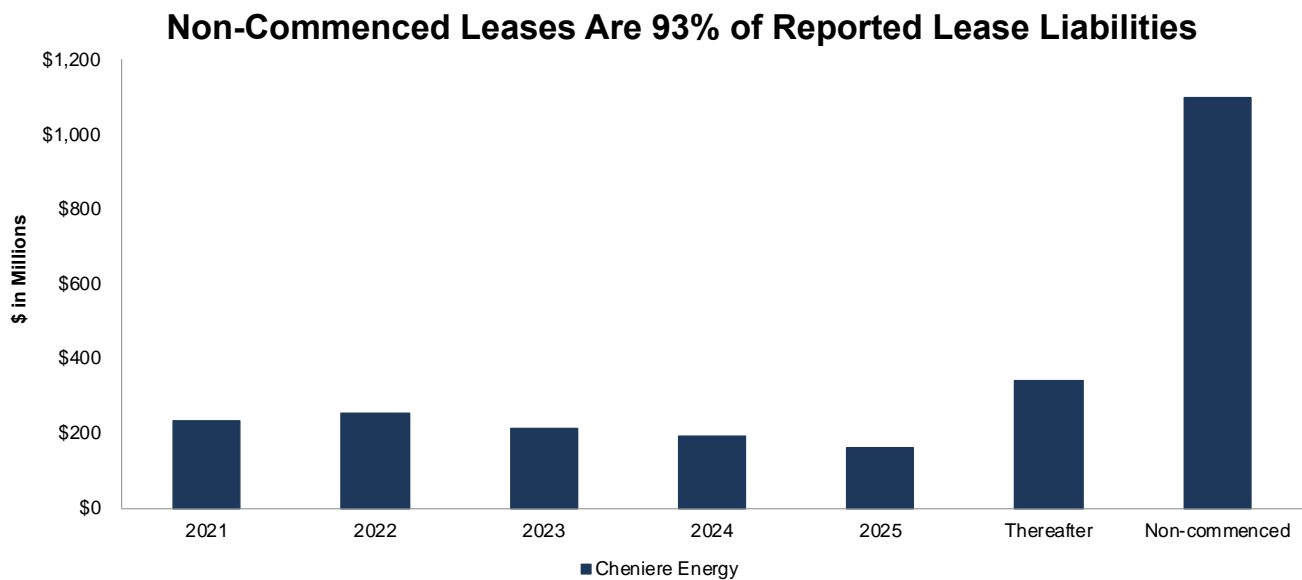
Sources: New Constructs, LLC and company filings

Cheniere Energy (LNG) – Non-Commenced Leases Are 93% Of Reported Lease Liability

Cheniere Energy’s reported operating lease liability as of 1Q21 is \$1.2 billion, while our calculated operating lease liability is 61% larger at \$1.9 billion. The discrepancy largely stems from Cheniere Energy’s \$1.1 billion in non-commenced leases, which are disclosed below in the yearly payments table on [page 21 of its 1Q21 10-Q](#).

In total, these non-commenced leases are equal to 93% of the firm’s reported operating lease liability, as shown in Figure 5. While the firm’s reported debt understates its total debt by just 2%, without diligent footnotes analysis, investors would be unaware of Cheniere’s significantly understated operating lease liabilities.

Figure 5: Cheniere Energy’s Non-Commenced Leases vs. Reported Yearly Payments – 1Q21 10-Q



Sources: New Constructs, LLC and company filings



Why This Diligence Matters – Required for Accurate Earnings Models

ASU 2016-02 aims to relieve investors of at least some of the rigorous footnotes analysis required to assess operating lease liabilities. However, as shown above, plenty of footnotes work remains to ensure we get the right value across 5,000+ companies for our clients and partners.

Our models leverage detailed footnotes analysis to capture the impact of off-balance sheet debt from operating leases on [NOPAT](#), [invested capital](#), (the two variables in our ROIC calculation) [economic book value/valuation](#) and the weighted-average cost of capital ([WACC](#)). This diligence is the backbone of our [more reliable](#) & [proprietary](#) fundamental data and research, as proven in [The Journal of Financial Economics](#).

Check out this week's [Danger Zone interview](#) with Chuck Jaffe of [Money Life](#).

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Best Fundamental Data in the World

Forthcoming in [The Journal of Financial Economics](#), a top peer-reviewed journal, [Core Earnings: New Data & Evidence](#) proves our Robo-Analyst technology overcomes material shortcomings in legacy firms’ data collection processes to provide superior [fundamental data](#), [earnings](#) models, and [research](#). More [details](#).

Key quotes from the paper:

- “[New Constructs’] *Total Adjustments* differs significantly from the items identified and excluded from Compustat’s adjusted earnings measures. For example... 50% to 70% of the variation in *Total Adjustments* is not explained by S&P Global’s (SPGI) *Adjustments* individually.” – pp. 14, 1st para.
- “A final source of differences [between New Constructs’ and S&P Global’s data] is due to data collection oversights...we identified cases where Compustat did not collect information relating to firms’ income that is useful in assessing core earnings.” – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg’s in [Getting ROIC Right](#). See the [Appendix](#) for direct comparison details.

Key quotes from the paper:

- “...an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC.” – pp. 8, 5th para.
- “The majority of the difference...comes from New Constructs’ machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies.” – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts’ stock ratings outperform those from human analysts as shown in this [paper](#) from Indiana’s Kelley School of Business. Bloomberg features the paper [here](#).

Key quotes from the paper:

- “the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant.” – pp. 6, 3rd para.
- “Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts.” – pp. 20, 3rd para.

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We believe every investor deserves to know the whole truth about the profitability and valuation of any company they consider for investment. More details on our cutting-edge technology and how we use it are [here](#).



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