Operating Lease Disclosures: Updating The Good, the Bad & the Non-Compliant

Many companies are still not complying with the Financial Accounting Standards Board's (FASB) new standard (ASU 2016-02) for reporting operating lease assets and liabilities on the balance sheet. This standard went into effect in 1Q19 and goes a long way towards closing the loophole that allows companies to hide trillions of dollars in capital off the balance sheet.

This report updates our previous research on the best and worst disclosure practices and highlights a troubling new disclosure tactic that enables companies to hide more operating leases off the balance sheet again.

Why Disclosure Matters – Required for Accurate Earnings Models

Without compliant disclosures, investors cannot measure corporate performance or, the focus of this report, the real value of operating lease ROU assets & liabilities. Our models leverage detailed footnotes analysis to capture the impact of off-balance sheet debt from operating leases on NOPAT/income statements, invested capital/balance sheets, 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.

Though ASU 2016-02 aims to relieve investors of at least some of the rigorous footnotes analysis required to assess operating lease liabilities, plenty of footnotes work remains to ensure we get the right value across 5,000+ companies for our clients and partners. Figure 1 shows just how different our measure of the NPV of operating leases is compared to what companies disclose.

Figure 1: Balance Sheet Impact: Large % Differences in Reported and Adjusted Operating Lease Assets

Company	Ticker	Reporting Period	Company-Reported Operating Leases ($mm)	Our Value of Operating Leases ($mm)	% Difference
Virgin Galactic Holdings	SPCE	2020	$27	$39	44%
Uber Technologies Inc.	UBER	2020	$1,719	$2,353	37%
Moderna Inc.	MRNA	2020	$103	$135	31%
Penn National Gaming	PENN	2020	$4,493	$5,775	29%
Six Flags Entertainment	SIX	2020	$201	$249	24%

Sources: New Constructs, LLC and company filings

Operating leases also distort EBIT/EBITDA, Core Earnings[1], and NOPAT. We resolve this distortion by removing sublease income, a non-operating item (excluding Real Estate and Restaurants), from operating expenses. Figure 2 shows how big an impact the sublease income adjustment has on Core Earnings. For example, Box Inc's (BOX) sublease income is 24% of Core Earnings. Again, investors need adequate disclosures from companies in order to get this data and gain an accurate understanding of corporate performance.

[1] Only Core Earnings enable investors to overcome the inaccuracies, omissions and biases in legacy fundamental data and research, as proven in Core Earnings: New Data & Evidence, a forthcoming paper in The Journal of Financial Economics written by professors at Harvard Business School (HBS) & MIT Sloan.

Figure 2: Income Statement Impact: Sublease Income Overstates Earnings

Company	Ticker	Annual Period	Sublease Income	% of Revenue	% of Core Earnings
Box Inc.	BOX	2020	$10,969,000	1.4%	24%
United Rentals Inc.	URI	2020	$142,000,000	1.7%	18%
Key Corp	KEY	2020	$167,000,000	2.3%	15%
Fluor Corp	FLR	2020	$6,797,000	>1%	13%

Sources: New Constructs, LLC and company filings

Even With New Rules, Companies Are Hiding Operating Leases Again

At the end of the day, FASB's narrowing the loophole that allowed companies to hide trillions of dollars in capital off the balance sheet was a good first step. However, it cannot be the last step.

In 2020 10-Ks and 2021 10-Qs "non-commenced" leases, or leases that a company has signed a contract and began making payments for, but are not yet available to use, are further obfuscating lease disclosures and lease ROU assets & liabilities.

These non-commenced leases are often disclosed in the yearly lease payments table or only in a separate footnote, which means these lease liabilities do not appear on balance sheets.

We will publish an upcoming report dedicated to this bad disclosure trend that will detail what investors need to know and how we will treat it moving forward.

Below, we provide new examples of good, bad, and non-compliant disclosures regarding operating leases.

The Good Disclosure Practices

We begin with examples of some of the best disclosures so that investors can see how good disclosures look and how easy it is for companies to provide them. Plus, they provide a point of reference for understanding just how bad the bad disclosures are.

Good Disclosure #1: ROU Assets & Liabilities: This 2020 10-K disclosure from Mimecast Ltd (MIME) of the operating lease ROU assets and current/long-term liabilities on the balance sheet is an example of the best disclosure of this information. In total, we estimate about 52% of companies provide this level of disclosure for their operating leases in 10-Ks and 10-Qs. Contact us to request more details on which companies provide the best/worst disclosures. Note that we will provide certain details to clients only.

Figure 3: Mimecast's Operating Lease Assets & Liabilities Disclosure in 2020 10-K

MIMECAST LIMITED
CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share amounts)

	As of March 31, 2020	As of March 31, 2019
Assets		
Current assets		
Cash and cash equivalents	$ 173,958	$ 137,576
Short-term investments	—	35,941
Accounts receivable, net	97,659	80,953
Deferred contract costs, net	11,133	8,140
Prepaid expenses and other current assets	16,145	25,871
Total current assets	298,895	288,481
Property and equipment, net	85,178	94,202
Operating lease right-of-use assets	116,564	—
Intangible assets, net	38,394	30,623
Goodwill	150,525	107,575
Deferred contract costs, net of current portion	36,664	28,250
Other assets	3,614	5,156
Total assets	$ 729,834	$ 554,287
Liabilities and shareholders' equity		
Current liabilities		
Accounts payable	$ 14,907	$ 9,457
Accrued expenses and other current liabilities	41,607	44,309
Deferred revenue	194,151	163,102
Current portion of finance lease obligations	1,058	844
Current portion of operating lease liabilities	30,379	—
Current portion of long-term debt	6,573	4,059
Total current liabilities	288,675	221,771
Deferred revenue, net of current portion	12,816	12,472
Long-term finance lease obligations	323	1,381
Operating lease liabilities	105,321	—
Long-term debt	86,258	92,797
Construction financing lease obligations	—	36,650
Other non-current liabilities	4,386	15,581
Total liabilities	497,779	380,652
Commitments and contingencies (Note 14)		
Shareholders' equity		
Ordinary shares, $0.012 par value, 300,000,000 shares authorized; 62,791,691 and 61,158,051 shares issued and outstanding as of March 31, 2020 and 2019, respectively	754	734
Additional paid-in capital	325,808	263,388
Accumulated deficit	(83,660)	(83,632)
Accumulated other comprehensive loss	(10,847)	(6,855)
Total shareholders' equity	232,055	173,635
Total liabilities and shareholders' equity	$ 729,834	$ 554,287

Sources: New Constructs, LLC and company filings

Good Disclosure #2: Future Annual Payments: This 2020 10-K disclosure from Mimecast of the future annual payments in an operating lease note, as a table, with a breakout of each individual year, is an example of the best disclosure of this information. In total, we estimate about 97% of companies provide this level of disclosure for their operating leases in 10-Ks and 64% in 10-Qs.

Figure 4 Mimecast's Future Annual Payments Disclosure in 2020 10-K

Maturities of lease liabilities as of March 31, 2020 were as follows:

Year Ending March 31,	Operating Leases		Finance Leases	
2021	$	36,231	$	1,102
2022		27,653		326
2023		21,291		—
2024		14,741		—
2025		14,254		—
Thereafter		43,516		—
Total lease payments		157,686		1,428
Less: imputed interest		(21,986)		(47)
Total lease liabilities	$	135,700	$	1,381

As of March 31, 2020, the Company had no additional operating or finance leases that have not yet commenced.

Sources: New Constructs, LLC and company filings

Good Disclosure #3: Discount Rate: This 2020 10-K disclosure from Mimecast of the discount rate used to determine the NPV of the operating lease payments in a table in the operating lease note is an example of the best disclosure of this information.

Figure 5: Mimecast's Operating Lease Discount Rate Disclosure in 2020 10-K

Weighted-average remaining lease term and discount rate:

	As of March 31, 2020
Weighted-average remaining lease term (in years)	
Operating leases	6.46
Finance leases	1.31
Weighted-average discount rate	
Operating leases	4.74%
Finance leases	4.83%

Sources: New Constructs, LLC and company filings

Good Disclosure #4: Sublease Income: This 2020 10-K disclosure from PayPal (PYPL) of sublease income reported in a table in the operating lease note is an example of the best disclosure of this information. In total, we estimate about 95% of companies provide this level of disclosure for their operating leases in 10-Ks and 96% in 10-Qs.

Sublease income is usually a non-operating item for most companies (with the exception of Real Estate and Restaurants) that reduces reported operating expenses, such as selling, general, and administrative. We add back sublease income in our adjusted EBIT/EBITDA, Core Earnings and NOPAT calculations because it leads to overstated profits and represents unusual income not core to the company's core operations.

Figure 6: PayPal Sublease Income Disclosure in 2020 10-K

	Year Ended December 31, 2020	2019
	(In millions)	
Lease expense		
Operating lease expense	$ 166	$ 136
Sublease income	(6)	(6)
Total lease expense	$ 160	$ 130

Sources: New Constructs, LLC and company filings

The Bad Disclosure Practices

The below examples include disclosures that are not as good as the prior examples because they make the information needed to assess operating leases harder to find in filings.

Bad Disclosure #1: ROU Assets & Liabilities: Instead of disclosing their operating lease ROU assets and liabilities on the balance sheet in the 2020 10-K, Applied Materials Inc. (AMAT) buries that information in "Other" on the balance sheet. Analysts and investors have to find the breakout of the "Other" value in the footnotes. It is far more convenient to get this data from the balance sheet and not have to search through potentially hundreds of pages of footnotes to find it. In total, we estimate about 32% of companies disclose ROU assets & liabilities this way in in 10-Ks and 22% in 10-Qs.

Figure 7: Applied Materials "Other Assets" Disclosure in the Footnotes in 2020 10-K

	October 25, 2020	October 27, 2019
	(In millions)	
Deferred Income Taxes and Other Assets		
Non-current deferred income taxes	$ 1,711	$ 1,766
Operating lease right-of-use assets	252	—
Income tax receivables and other assets	260	265
	$ 2,223	$ 2,031

	October 25, 2020	October 27, 2019
	(In millions)	
Accounts Payable and Accrued Expenses		
Accounts payable	$ 1,124	$ 958
Compensation and employee benefits	800	559
Warranty	201	196
Dividends payable	201	192
Income taxes payable	222	160
Other accrued taxes	33	55
Interest payable	36	38
Operating lease liabilities, current	64	—
Other	457	353
	$ 3,138	$ 2,511

	October 25, 2020	October 27, 2019
	(In millions)	
Other Liabilities		
Defined and postretirement benefit plans	$ 241	$ 212
Operating lease liabilities, non-current	195	—
Other	226	163
	$ 662	$ 375

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Sources: New Constructs, LLC and company filings

Bad Disclosure #2: ROU Assets & Liabilities: In Figure 8, Atlantic Capital Bancshares Inc. (ACBI) double buries, or makes it doubly hard to find, its operating lease right-of-use assets and liabilities in its 2020 10-K. Instead of being on the balance sheet directly or disclosed in a table in the footnotes, we have to dig further into the text supporting the footnotes table to find the operating lease/ROU values.

Figure 8: Atlantic Capital Operating Lease Disclosures Buried in Footnotes in 2020 10-K

The Company's leases relate primarily to office space and bank branches with remaining lease terms of generally 1 to 12 years. Certain lease arrangements contain extension options which typically range from 5 to 10 years at the then fair market rental rates. As these extension options are not generally considered reasonably certain of exercise, they are not included in the lease term. Portions of certain properties are subleased for terms extending through 2024. As of December 31, 2020, operating lease ROU assets and liabilities were $9.9 million and $14.9 million, respectively, compared to $11.9 million and $16.9 million, respectively, as of December 31, 2019. The Company elected not to include short-term leases (i.e., leases with initial terms of twelve months or less) on the Consolidated Balance Sheets. Additionally, the Company elected, for all classes of underlying assets, not to separate lease and non-lease components and instead to account for them as a single lease component. The Company's leases include variable lease payments with annual increases based on changes in market rental rates.

Sources: New Constructs, LLC and company filings

Bad Disclosure #3: Future Annual Payments: In Figure 9, Two Harbors (TWO) discloses its future annual payments in an "aggregate contractual obligations" table in its 2020 10-K, rather than breaking out the values in a table specifically related to operating leases. In total, we estimate about 1% of companies disclose annual payments in this way in 10-Ks and less than 1% in 10-Qs.

Figure 9: Two Harbors Future Annual Payments Bundled in Unrelated Table in 2020 10-K

Aggregate Contractual Obligations

The following table summarizes the effect on our liquidity and cash flows from contractual obligations for repurchase agreements, revolving credit facilities, convertible senior notes, interest expense on borrowings and our non-cancelable office leases, net of contractual subleases:

	Due During the Year Ended December 31,						
(in thousands)	2021	2022	2023	2024	2025	Thereafter	Total
Repurchase agreements	$ 15,143,898	$ —	$ —	$ —	$ —	$ —	$ 15,143,898
Revolving credit facilities	60,000	223,830	—	—	—	—	283,830
Convertible senior notes	—	286,183	—	—	—	—	286,183
Interest expense on borrowings[1]	31,789	2,055	—	—	—	—	33,844
Long-term operating lease obligations	1,751	1,259	501	—	—	—	3,511
Total	$ 15,237,438	$ 513,327	$ 501	$ —	$ —	$ —	$ 15,751,266

(1) Interest expense on borrowings calculated based on rates at December 31, 2020.

Sources: New Constructs, LLC and company filings

Bad Disclosure #4: Discount Rate: Colgate-Palmolive (CL) makes its operating lease discount rate difficult to find in its 2020 10-K by only disclosing it in a supporting paragraph and not in the operating lease table.

Figure 10: Colgate-Palmolive Operating Lease Discount Rate Buried in Text in 2020 10-K

COLGATE-PALMOLIVE COMPANY

Notes to Consolidated Financial Statements (continued)

(Dollars in Millions Except Share and Per Share Amounts)

Supplemental cash flow information related to operating leases for the twelve months ended December 31, 2020 and 2019 was as follows:

- Payments against amounts included in the measurement of lease liabilities: $193 and $202, respectively
- Lease assets obtained in exchange for lease liabilities: $163 and $232, respectively.

As of December 31, 2020 and 2019, the weighted-average remaining lease term for operating leases was 8 and 8 years, respectively, and the weighted-average discount rate for operating leases was 4.2% and 4.1%, respectively.

There were no material operating leases that the Company had entered into and that were yet to commence as of December 31, 2020.

Sources: New Constructs, LLC and company filings

Bad Disclosure #5: Sublease Income: Figure 11 shows how Identiv Inc. (INVE) discloses sublease income in its 2020 10-K, but only within a paragraph and not a separate table. This disclosure practice is more difficult to identify, especially in filings that can run 200+ pages. In this case, sublease income was disclosed in an unrelated paragraph. In total, we estimate about 5% of companies disclose sublease income in this way in 10-Ks and 4% in 10-Qs.

Figure 11: Identiv Sublease Income Disclosed in Paragraph in 2020 10-K

15. Restructuring and Severance

During the year ended December 31, 2019, the Company incurred restructuring and severance related costs of $105,000. These costs were partially offset by the reversal of a restructuring accrual of $91,000 for future rental payment obligations associated with vacated office space at its Fremont, California facility, which was sublet in the third quarter of 2019.

In the year ended December 31, 2020, the Company incurred restructuring expenses of $1,716,000, consisting of severance related costs of $375,000, and facility rental related costs associated with office space of an acquired business of approximately $1,341,000. The latter included a charge of $1,100,000 associated with the impairment of the ROU operating lease asset, which was subleased, but subsequently went into default due to non-payment of rent beginning April 1, 2020 Sublease income of $198,000 was received in the first quarter of 2020 however, since the first quarter of 2020, no rental payments were received.

Sources: New Constructs, LLC and company filings

The Ugly (and at Times Non-Compliant) Disclosure Practices

These disclosures lack information necessary for investors and analysts to fully measure the impact of a firm's operating leases on its fundamentals.

Ugly Disclosure #1: ROU Assets & Liabilities: Instead of disclosing operating lease ROU assets and liabilities on the balance sheet in its 2020 10-K, Netflix Inc. (NFLX) buries that information in "Other" on the balance sheet. However, unlike the AMAT example above, Netflix does not break out "Other" in any way in the footnotes, which leaves analysts unable to analyze and adjust for operating leases.

Figure 12: Netflix Operating Lease ROU Assets & Liabilities Bundled in "Other" in 2020 10-K

(1) Balance as of December 31, 2019 includes $743 million for operating leases existing on January 1, 2019.

	As of December 31,			
	2020		2019	
	(in thousands, except lease term and discount rate)			
Operating lease right-of-use assets, net	$	2,037,726	$	1,532,285
Current operating lease liabilities	$	256,222	$	190,622
Non-current operating lease liabilities		1,945,631		1,422,612
Total operating lease liabilities	$	2,201,853	$	1,613,234

Sources: New Constructs, LLC and company filings

Ugly Disclosure #2 (that is also non-compliant): Future Annual Payments: Figure 13 shows that Old Republic International Corp (ORI) is not compliant with GAAP as it groups future annual payments in its 2020 10-K into multi-year timeframes. Under GAAP, aggregation of future annual payments is only allowed in the thereafter portion following five individual years. Aggregating multiple years prior to the first five makes it more difficult to assess the accuracy of the firm's NPV calculation. In total, we estimate about 1.5% of companies disclose future annual payments in this way in 10-Ks and 2% in 10-Qs.

Figure 13: Old Republic Non- Compliant Future Annual Payment Disclosure in 2020 10-K

Contractual Obligations - The following table shows certain information relating to the required reporting of contractual obligations as of December 31, 2020:

	2021	2022 and 2023	2024 and 2025	2026 and After	Total
Contractual Obligations:					
Debt	$ 21.7	$ —	$ 400.0	$ 550.0	$ 971.7
Interest on Debt	40.8	81.6	62.1	21.3	205.9
Operating Leases	61.3	97.8	61.2	96.4	316.8
Pension Benefits Contributions (a)	—	17.8	27.2	26.3	71.3
Claim & Claim Expense Reserves (b)	2,813.1	2,468.0	1,430.8	3,959.0	10,671.0
Total	$ 2,937.1	$ 2,665.2	$ 1,981.4	$ 4,653.1	$ 12,236.9

Sources: New Constructs, LLC and company filings

Ugly Disclosure #3: ROU Assets & Liabilities: Figure 14 illustrates how Old Republic International combines many of the worst disclosures from above by only mentioning operating lease ROU assets & liabilities in a paragraph in its 2020 10-K.

Figure 14: Old Republic Operating Lease ROU Assets & Liabilities Lack Necessary Context in 2020 10-K

Effective January 1, 2019, the Company adopted new lease accounting guidance issued by the FASB which requires the balance sheet recognition of all leases with a term greater than 12 months. The Company's adoption of this standard resulted in the establishment of a right of use asset ($226.9) and corresponding lease liability ($241.4) equal to the present value of future lease payments, reflected within sundry assets and liabilities in the consolidated balance sheet. Furthermore, the Company recognized $18.4, net of tax, in previously deferred gains associated with sale leaseback transactions as an adjustment to beginning retained earnings.

Sources: New Constructs, LLC and company filings

Ugly Disclosure #4: Discount Rate: Lemonade Inc. (LMND) provides a breakdown of its future annual payments in its 2020 10-K but does not disclose the discount rate used to calculate these payments. Without disclosing the discount rate, analysts cannot judge the appropriateness of the rate used and whether the balance sheet impact of the operating leases is reasonable. In total, we estimate about 8% of companies provide this level of disclosure for their operating leases in 10-Ks and 45% in 10-Qs.

Figure 15: Lemonade Inc. Lack of Discount Rate Disclosure in 2020 10-K

Lease commitments

The Company and its subsidiaries lease their facilities under various operating lease agreements. The Company's headquarters in New York is under a lease that expires in November 2022. The Company's Israel based operations occupy offices with lease expiration dates that extend through July 2026. On March 18, 2019, the Company entered into a lease agreement to lease office space in Scottsdale, Arizona that expires in November 2024.

Aggregate minimum rental commitments under non-cancelable operating leases at December 31, 2020 are as follows ($ in millions):

2021	$ 4.8
2022	5.0
2023	2.8
2024	2.8
2025 and thereafter	4.4
	$ 19.8

Future annual payments disclosed but no discount rate provided

Sources: New Constructs, LLC and company filings

Ugly Disclosure #5: Sublease Income: Per Figure 16, United Natural Foods (UNFI) disclosed the exact amount of sublease income in its 2020 10-K, but omits this important data in its 1Q21 10-Q. United Natural Foods does not even mention sublease income in its 1Q21 10-Q. This poor disclosure makes it impossible for investors to know and adjust earnings for sublease income.

Figure 16: United Natural Foods Discloses Sublease Income in 2020 10-K

Lease assets and liabilities presented in the table above include lease contracts related to our discontinued operations, as the Company expects to remain primarily obligated under these leases.

The Company's lease cost under ASC 842 is as follows:

(in thousands)	Consolidated Statements of Operations Location	August 1, 2020
Operating lease cost	Operating expenses	$ 223,016
Short-term lease cost	Operating expenses	30,992
Variable lease cost	Operating expenses	151,065
Sublease income	Operating expenses	(3,504)
Sublease income	Net sales	(22,543)
Other sublease income, net	Restructuring, acquisition and integration related expenses^(2)	(5,075)
Net operating lease cost^(1)		373,951
Amortization of leased assets	Operating expenses	16,052
Interest on lease liabilities	Interest expense, net	11,617
Finance lease cost		27,669
Total net lease cost		$ 401,620

Sources: New Constructs, LLC and company filings

Note that when companies make no mention of sublease income whatsoever, we do not know whether or not they have sublease income. We have to assume that companies disclose the existence of any material amounts of sublease income. However, given that we see companies not disclose material information in other areas, we also have to assume that some companies with material sublease income may have it, but do not disclose it.

Without adequate enforcement of disclosure compliance, investors are unable to make fully informed decisions.

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Disclosure: David Trainer, Kyle Guske II, Alex Sword, Hunter Anderson, and Matt Shuler receive no compensation to write about any specific stock, style, or theme.

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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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