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Accounting 610 – Lease Project

The Gap, Inc

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Executive Summary

For this project, we took a closer look at a proposed change in the way leases are recorded. The two ways in the current standard that leases are recorded fall under the title of an “operating lease” (rental) or a “capital lease” (ownership). The proposed standard will have all the leases put into capital lease, which for some companies can really affect their financial statements, as well as their ratios. The supporters of this proposed standard view this as the “right to use method”, which basically states that the right to use a leased asset is an asset and the commitment to make lease payments is a liability. The current standard seems more logical in this case because with the current standard, operating leases require the lessor to reflect the ownership of the asset but the lessee only has to place the periodic rent payment on the profit and loss account as an expense. We feel that a company shouldn’t be forced to record something as if they own it, especially when they actually don’t own it. By recording it as if they do own it (proposed capital lease), then that will actually hurt their financial statements and ratios as we’ve shown in this paper with the Gap, Inc. If the proposed standard comes into play, and operating lease payments are acknowledged as liabilities, then that will cause a big negative change in the company’s financial statements, which could lead to less investors since the company’s financial numbers and ratios won’t look so attractive in the end. Overall, we propose that the current standard for leases stays in effect, and in this paper we support this decision with facts and spreadsheets to show why we came to this conclusion.

Main Paper

Before starting this lease paper, we had to examine the current and proposed lease accounting standards in more detail to get a better understanding of the topic at hand. After reading many articles, we were surprised on how much the proposed standard can really affect a company if it's adopted as the new standard for leasing. We were so surprised that later in this paper, we will show how this potential change would affect a well-known current apparel retailer by the name of The Gap, Inc.

After doing research, it seems that a great deal of companies prefer to categorize their leases as operating leases instead of capital leases. Before we get into the benefits of these types of leases for a company, we found a useful website that explained how to know whether the lease should be classified as an operating lease or a capital lease. According to www.investopedia.com:

"A lessee (the company leasing equipment) should classify a lease transaction as a capital lease if it is non-cancelable and if one or more of the four classification criteria are met:

- The agreement specifies that ownership of the asset transfers to the lessee.
- The agreement contains a bargain purchase option.
- The non-cancelable lease term is equal to 75% or more of the expected economic life of the asset.
- The present value of the minimum lease payments is equal to or greater than 90% of the fair value of the asset.

If none of these criteria are met, the lease can be classified as an operating lease" (Capital and Operating Leases, 2013). Currently, these rules above classify whether a company can record their leases as a capital or an operating, but this is where the proposed standard will require all companies to record their leases as capital leases and make these lease payments a liability. Say there is an investor who is not clear on the current or proposed accounting lease rules, then they might say, what's the big deal if a company classifies their leases as either one (Operating or Capital)? To clarify this, we decided to talk about the benefits for the company whether they have to report their leases as a capital or an operating lease.

To start, we looked into the current standard with the operating lease recorded. Some benefits for the company with the current standard in place and if the leases recorded as operating are:

- Assets and liabilities that are linked with the lease are not recorded or shown on the balance sheet, which would end up showing a greater return on assets (ROA) for the company
- A company will show better debt covenant ratios to its lenders since operating leases don't need to record assets and liabilities in the balance sheet. This eventually leads to the establishment of off-balance sheet financing for the company

- With an operating expense, the owner can reap the tax benefits of the asset that is leased
- In an operating lease, the lessee doesn't take in the risks of ownership
- Companies that record operating leases usually show much better ratios than they would have if it were a capital lease

A couple benefits with leases being recorded as a capital lease are:

- Since there would be no operating expense with a capital lease, then that means the company's Operating cash flow would be higher
- With net income being decreased because of the lease expenses, this technically will also decrease any tax rates and/or expense.

Obviously, both the operating lease and capital lease have their own benefits, and each one affects the financial statements in different ways, but we also found a chart that was put out from New York University that shows how each lease affects the company's ratios and operating income (*Damodaran, NYU.edu, 2009*):

Table 2: Effects of Operating and Capitalized Leases

Ratio	Effect of Operating Lease	Effect of Capital Lease
Return on Capital or ROIC = $\frac{\text{EBIT} (1 - t)}{\text{BV of Capital}}$	• Decreases operating income through lease expense • Capital does not reflect leases • ROC is generally higher	• Decreases operating income only through depreciation. • Capital increases through present value of operating lease. • ROC is generally lower
Return on Equity (ROE) = $\frac{\text{Net Income}}{\text{BV of Equity}}$	• Net income lowered by after-tax lease expense • BV of Equity unaffected • ROE effect depends on whether lease expense > (imputed interest + depreciation)	• Net income lowered by after-tax interest expense & depreciation on leased asset. • BV of Equity unaffected • ROE effect depends on whether lease expense > (imputed interest + depreciation)
Interest Coverage = $\frac{\text{EBIT}}{\text{Interest Expense}}$	• Operating income generally decreases. • Interest expense does not include leases. • Coverage ratio generally higher	• Operating income decreases • Interest expense increases to reflect imputed interest on leases • Coverage Ratio generally lower
Debt Ratio = $\frac{\text{Debt}}{(\text{Debt} + \text{Equity})}$	• Debt includes only conventional debt (no leases) • Debt Ratio is lower, both in book and market terms.	• Debt increases (to account for capitalized leases) • Debt Ratio is higher

As you can see on the chart above, in regard to the Return on Capital, it decreases operating income through lease expense when using it as an operating lease, whereas its decreased only through depreciation when its used as a capital lease. The depreciation the main difference in operating income because when looking at operating income through interest coverage, it usually just decreases with

either lease. The Return on Capital (ROC) is mostly greater with the operating lease, whereas with the capital lease, the ROC tends to be less. When looking at the solvency (debt/equity ratio), recording as an operating lease will show a better ratio than if it were recorded as a capital lease, which has a higher debt ratio. Aside from the chart above, there are more ratios that will be affected by the decision of capital lease vs. operating lease, and these ratios include the current ratio (liquidity), working capital, and asset turnover.

With the current ratio, it tends to be higher in the operating lease, than it is in the capital lease. Having a higher current ratio is a plus for companies because then they have a better sense and more confidence that they can pay-off their short-term liabilities with their short-term assets. A company with a low current ratio may be signaling that they are having trouble paying off its commitments. Like the current ratio, the working capital for a company tends to be higher when recorded in an operating lease. As a company, you definitely want your working capital ratio to be higher because that shows you are efficient and are in good short-term financial shape. For the asset turnover ratio, this shows if you are increasing in revenue corresponding to sales, which is basically saying how efficient you are at utilizing your assets in triggering sales. Obviously, a company would want the higher ratio here, and they would likely get the higher ratio with an operating lease over the capital lease. These are just some of the important ratios that would be affected by the decision of recording a capital lease or an operating lease, but statistics like this are exactly what someone like an investor with no knowledge on these old/new accounting standards would need to possibly make a decision to invest in the company or not.

Some industries would be affected by this change from the current standard on how leases are recorded to this new proposed standard, more than others. This proposed standard would force the lessees to handle all leases as capital leases. The supporters of this proposed standard view this as the "right to use method", which basically states that the right to use a leased asset is an asset and the commitment to make lease payments is a liability. In essence, they believe if you are using it then it's an asset to you, which we believe shouldn't be true. For example, one industry that would be affected that we are going to talk about is the specialty retailer: apparel industry. To be more specific in this industry, we will use The Gap, Inc, as an example because that is a company that one of us researched for the annual report project. The Gap rents its stores whether it's in a mall, strip mall, or just their store, and with this proposed standard, they would have to record this in the balance sheet as if they are the owners of the property, which makes no sense because they don't own the property. We do understand the argument of "if you committed to make lease payments, then those payments are technically a liability", but at the same time, we only believe that statement is true if you have ownership of whatever it is you are paying. The current standard seems more logical in this case because with the current standard, "Operating leases require the lessor to reflect the ownership of the asset but the lessee only has to place the periodic rent payment on the profit and loss account as an expense" (Crosby, Article 5, 2003). We feel that a company shouldn't be forced to record something as if they own it, especially when they actually don't own it.

The effect of capital and operating lease on the Gap's financial statements:

Balance Sheet:

When we look at the effect that will happen to the balance sheet of Gap if they decided to use the capital lease method, we will see that capital lease will make the equipment appear as a fixed asset in the balance sheet. At the same time, the company will also recognize a liability on the balance sheet, by an amount equal to the present value of the minimum lease payments. But if they keep using the operating lease there won't be any assets or liabilities recorded (Shown in Chart B). Since the company's asset base is reported lower the immediate benefit would be a higher ROA than it would display had it classified the lease as a capital lease requiring a higher asset base.

Operating lease creates off-balance sheet financing because no liability is recorded on the balance sheet since no asset is recorded. The advantage the Gap is gaining while not having those leases recorded on the balance sheet is that, the company would display to its debt lenders better debt covenant ratios, which will eventually reduce the risk of lending them money therefore getting lower interest rates.

Income statement:

Under the operating lease standard the Gap is considered to be renting the equipment and therefore the lease payment is considered to be a rental expense, this fact will eliminate the depreciation expense and interest expense in the case of capital lease, which will make the Gap, be the owner of the equipment. However, a firm with a lower tax bracket will have incentives to classify a lease as an operating lease, because this standard allows them to minimize the amount of money they would pay as taxes if they decided to use the capital lease standard. As you can see in (Chart C), EBIT is constant for the five coming years using the capital lease standard, and taxes are not required in the operating lease standard when there are only operating expenses for the five coming years.

Liquidity, leverage and solvency:

Leverage and liquidity ratios will be affected by the addition of current and noncurrent liabilities, which are associated with the use of capital lease standard, and they remain the same with the use of operating lease standard. For the Gap, signing a capital lease agreement would add operational consequences, especially in the loan payment budgeting process, that affect future liquidity and solvency. This is because interest remittances reduce how much money the business will make over the lease term; in addition, other lenders may charge higher interest rates if they perceive the organization as a high credit risk. The future effect on liquidity and solvency comes from the fact that a capital lease increases corporate indebtedness, and financial analysts might reduce a company's solvency levels accordingly - especially if the corresponding resource's worth decreases over time, usually through accounting depreciation caused by capital lease standard (Codjia, 2011).

Cash Flow:

Cash flow statement - Total cash flow statements remain unaffected by both operating and capital leases. However, cash flow from operations includes only the

interest portion of the capital lease expense. The principal payment will be included as a cash outflow from cash flow from financing activities. As a result, capital leases will overstate CFO and understate CFF. On the other hand, cash flow from operations includes the total lease payment for the specified accounting period. In the Gap's case, these differences are shown in (Chart D).

Return on Equity:

If the Gap decided to use the capital lease standard, this will result in lower returns on equity, which results in lower growth in the short run. The DuPont ratio for calculating return on equity consists of net income margins, total asset turnover and leverage. As the company records depreciation and interest expense on the lease, net income margins decline due to lower net income and total asset turnover declines due to higher asset levels. The combined effect of this results in a lower return on equity.

Conclusion:

If the proposed standard comes into play, and operating lease payments are acknowledged as liabilities, then that will cause a very big change in the company's key ratios, balance sheet, and possibly turn away potential investors. The reason this might result in less investors is because now the company would have to possibly put out not so attractive numbers as a result of the proposed standard. Overall, with all our facts listed in this paper, as well as the proof from the numbers in the charts, this is why we propose that the current standard for leases stays in effect, instead of the proposed standard, which clearly could be fatal for some companies operating today.

Charts:

Chart A: Beginning of the year payment

year	Beg of year liability balance	payment	Interest Expense	Reduction in liability	Adjusted Liability balance
2013	3531.95	884.60	282.56	602.04	2929.91
2014	2929.91	884.60	234.39	650.21	2279.70
2015	2279.70	884.60	182.38	702.22	1577.48
2016	1577.48	884.60	126.20	758.40	819.07
2017	819.07	884.60	65.53	819.07	0.00

Straight-line depreciation: $3531.95/5 = 706.39$

YEAR	VALUE	USEFUL LIFE	STRAIGHT LINE DEP	ACCUMULATED DEP	BOOK VALUE
2013	3531.95	5.00	706.39	706.39	2825.56
2014	3531.95	5.00	706.39	1412.78	2119.17
2015	3531.95	5.00	706.39	2119.17	1412.78
2016	3531.95	5.00	706.39	2825.56	706.39
2017	3531.95	5.00	706.39	3531.95	0.00

Chart B: Balance Sheet

Balance sheet Option 1 Capital Lease				Balance sheet Option 2 Operating Lease			
YEAR	Assets	Liability	Shareholder's equity	Assets	Liability	Shareholder's equity	
2013	2825.56	\$2,929.91	\$988.95	-	-	1,093	
2014	2119.17	\$2,279.70	\$940.78	-	-	1,069	
2015	1412.78	\$1,577.48	\$888.77	-	-	924	
2016	706.39	\$819.07	\$832.59	-	-	753	
2017	0.00	\$0.00	\$771.92	-	-	584	
			\$4,423.00			\$ 4,423.00	

Chart C: Income Statement

Income Statement Option 1 Capital Lease				Income Statement Option 2 Operating Lease	
Year	Operating Expense included in (EBIT)	Non operating expense (interest) included in EBT	TOTAL EXPENSE	Operating Expense = Total expense	Difference capital vs. Operating lease
2013	706.39	283	989	1,093	(104.05)
2014	706.39	234	941	1,069	(128.22)
2015	706.39	182	889	924	(35.23)
2016	706.39	126	833	753	79.59
2017	706.39	66	772	584	187.92

Chart D: Cash Flow Statement

Cash Flow Statement Option 1 Capital Lease				Cash Flow Statement Option 2 Operating Lease		
Year	CFO	CFF	TOTAL CASH FLOW	CFO	CFF	TOTAL CASH FLOW
2013	(283)	(602.04)	(885)	(1093)	0	(1093)
2014	(234)	(650.21)	(885)	(1069)	0	(1069)
2015	(182)	(702.22)	(885)	(924)	0	(924)
2016	(126)	(758.40)	(885)	(753)	0	(753)
2017	(66)	(819.07)	(885)	(584)	0	(584)

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