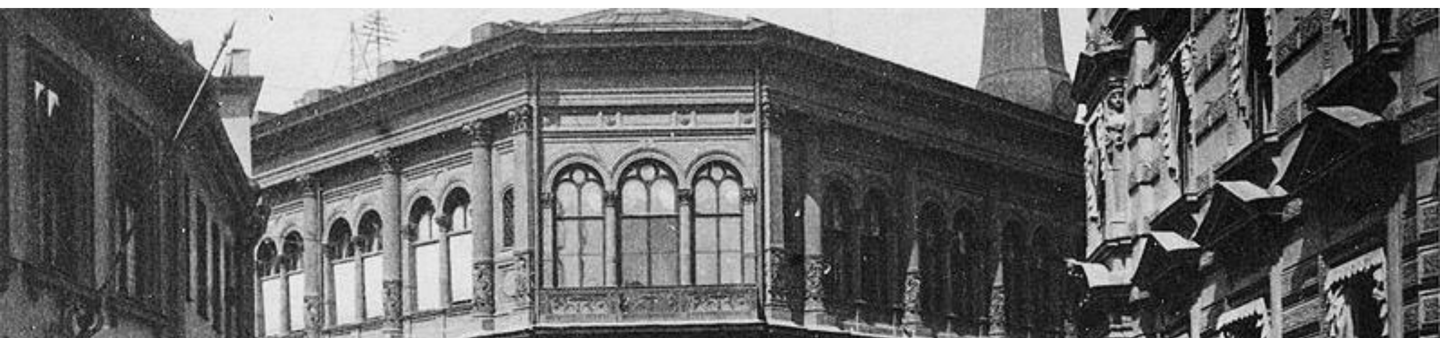
CLAY TOKENS

The Uniform Accounting Monthly Report | April 30, 2021



Deficiencies in GAAP/IFRS vis a vis Uniform Accounting

Presented to the UAFRS Advisory Council

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Four reasons that lease accounting distorted reality… have now become five

I recently had a wonderful conversation with Ralph Nach. Ralph is a former co-author of the Wiley GAAP Guide. He teaches continuing professional education courses for practicing CPAs on many of the most difficult and complex accounting topics. Ralph was also one of the very first members of the UAFRS Advisory Council for Uniform Accounting.

To cover the new accounting rules for lease capitalization, Ralph has a remarkable four-hour module on just this subject alone. It's not for the faint of heart. Yet, it's necessary if you want to understand just how confusing lease accounting has become. The new rules that were designed to help the profession. Unfortunately, they haven't.

I shared with Ralph how I had conducted a short seminar called "The Dark Side of Accounting" for a Chartered Financial Analyst (CFA) Society a few years ago. That program title has been quite popular with financial analysts around the world.

I was discussing the arcane lease accounting rules and the arbitrary, yet material, impact lease classification rules can have. Understanding the directionally-changing impact that lease accounting can have on the cash flow statement and balance sheet are a bane for CPA exam takers as well as seasoned CFOs worldwide.

I asked this group of finance-savvy practitioners if anyone in the audience could even remember the four ways a lease could be deemed a capital lease. A few were able to blurt out some fragments of the accounting code like "present value" or "long lease term."

As others rummaged through old mental cobwebs for answers, there were a few guys sitting together in the back of the room that raised their hands quite confidently.

Reading their self-assurance, I called on them to explain to the audience what they knew.

Actually, it was quite impressive. One rattled off the criteria perfectly: shift in ownership; bargain purchase option, lease term exceeding 75% of the asset life, and present value of the lease payments exceeding 90% of the fair value of the leased asset at inception.

I wondered if they were recent CPA exam passers who happened to be in the CFA audience. They were not. I asked if they were public accountants who specialized in this area. I struck out on that as well.

How did this group know the rules so well? It turns out they worked at the industrial giant, Siemens, on a team that sells and leases very large and very expensive industrial equipment.

And the reason they knew the accounting so well? Because that is part and parcel of their client contract creation. The team would specifically ask clients whether they preferred the pending lease to be on the books as a capital lease asset, along with associated debt... or to not trigger these criteria so that the client's books would not reflect any leased asset or associated debt.

The team was highly skilled in building contracts for clients so that the terms would pass the criteria tests to book the lease - or not - as the client requested.

Better than I possibly could have, the team gave a wonderful example of how lease capitalizations had been arbitrary in nature.

Please don't hate the player. Hate the game.

Years ago, many standards-setters responsible for the FASB and IASB accounting governance regimes identified that this problem effectively made lease capitalization an election by each company. They sought to fix the issue and also find a common path for GAAP and IFRS to have at least one really solid example of globally consistent financial statements.

As the guidance has come to light, and CFOs and their auditors have been implementing the new rules, we have learned that the effort has been a colossal failure on every level possible.

The accounting rules for leases are even more complex than before. US GAAP and IFRS have not fully converged, as US companies are still required to classify their leases as being either finance leases or operating leases. And the four-way criteria test is now a five-way test.

Under the new standard, both operating leases and finance leases are presented on the balance sheet as a right-of-use asset and a corresponding liability.

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Where the U.S. version of the standard really tests credulity, however, is in the income statement. The U.S. version of the standard requires the combined interest on the lease obligation - including the amortization of the right-of-use asset subject to an operating lease - to be aggregated and charged as a rent expense on a straight-line basis over the lease term.

There is absolutely no reasonable explanation for this treatment since the economics of leasing are such that the lessee is entering into a financing transaction to purchase the exclusive use of the leased asset over the lease term.

Financing transactions result in more interest expense in the early years of the obligation, and as principal is paid down, that interest expense declines over time.

Only the right-of-use asset (the intangible right to use the leased asset) should be amortized to income using the straight-line method over the term of the lease.

Under the new regimen, as issued by IASB, there would be no need to classify a lease and no five-step test to perform. There also would be no opportunity for lessors and lessees to collude and financially engineer the lease to meet customer/lessee desired accounting treatment.

The accounting standard setters seemed to have been lobbied by the leasing industry such that the new accounting guidance would not produce a higher charge to earnings in the near-term.

Maybe they feared that investors would see a lower earnings number from treating all leases as financing and then sell the stocks of those companies with supposedly deteriorating earnings.

The truth is, no investor worth their salt would ever rely on unadjusted GAAP earnings in performing their investment analysis.

So, as Ralph explained quite eloquently, on an operating lease, the imputed interest expense and the amortization expense attributed to the capitalized lease cannot, in aggregate, exceed the artificially derived straight-line expense computed in each year.

This mathematically results in escalating amortization of the lease asset in later years to offset the decreases in the imputed interest expense on the lease obligation. Stated differently, the imputed cost of interest falls over the life of a lease, as it would have had the asset been purchased with debt. That’s not strange.

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What is totally strange is that the amortization expense actually rises over time. This serves to fudge the fact that the total of the amortization and imputed interest cannot exceed the expense computed by taking the total of both and dividing it by the number of years of the lease term.

This suggests that the highest period of utility of an operating lease is in the final years of its life. That simply does not reflect economic reality and violates something I remember being taught, called the matching principle. The earlier years of the asset's life are charged with the lightest amortization expense under the new accounting.

The new accounting rules in the U.S violate anyone's sense of how capital assets ought to be depreciated, whether leased or otherwise.

Finally, I asked Ralph about the future of Uniform Accounting and its importance to executives. His response,

"Well, GAAP is not going anywhere anytime soon. So Uniform Accounting has a bright future… there will still be a need to make these adjustments. It's going to be a necessary tool to be able to make valid comparisons between companies and to really evaluate the economics and the valuation of companies on a consistent basis…"

On that note, please find a few examples this month of just how inconsistent and distorted as-reported numbers can be, courtesy of Uniform Accounting adjustments.

The report name "Clay Tokens" comes from the earliest known form of accounting and bookkeeping and a foundation for tracking the earliest debits and credits. In this regard, Uniform Accounting is an attempt to get financial statements back to the foundations of the purpose of accounting… to be useful to the users of the accounting information. Clay Tokens is produced monthly by Valens Research on behalf of and for the UAFRS Advisory Council for Uniform Adjusted Financial Reporting Standards.

Deficiencies in GAAP/IFRS vis a vis Uniform Accounting

EL – Estée Lauder

Prior to the pandemic, EL's Uniform earning power had grown steadily more robust in each year (Exhibit 1a)

In parallel to this UAFRS-based earnings trend, the market rewarded the firm with steady and material stock price appreciation

Meanwhile, GAAP earnings had remained stagnant over this time period, hovering near corporate averages, misleading investors into incorrectly believing the firm had struggled to improve on its performance

From 2015 to 2020, EL shares skyrocketed, rising from approximately $75/share to over $210/share, an almost 3x price appreciation (Exhibit 1b). That said, according to the market, EL appeared to be a firm with seen stable and average profitability, and not one with robust and improving fundamentals which would warrant such success.

However, using Uniform Accounting, we can identify distortions such as a firm's earnings being understated due to a mistreatment of operating leases and their associated interest and amortization expenses. Meanwhile, as also highlighted in the introduction, the firm's lease assets are being mishandled as right-of-use assets and corresponding liabilities, due to the faulty restructuring of lease accounting standards.

According to as-reported metrics, EL maintained an average 11%-13% ROA since 2015, implying the firm has a stable, yet potentially, stagnant business model Meanwhile, UAFRS-adjusted metrics paint a significantly different picture of EL, where Uniform ROA expanded materially from 22% to 28% over the same timeframe, suggesting the firm's stock price appreciation may have been justified (Exhibit 1c).

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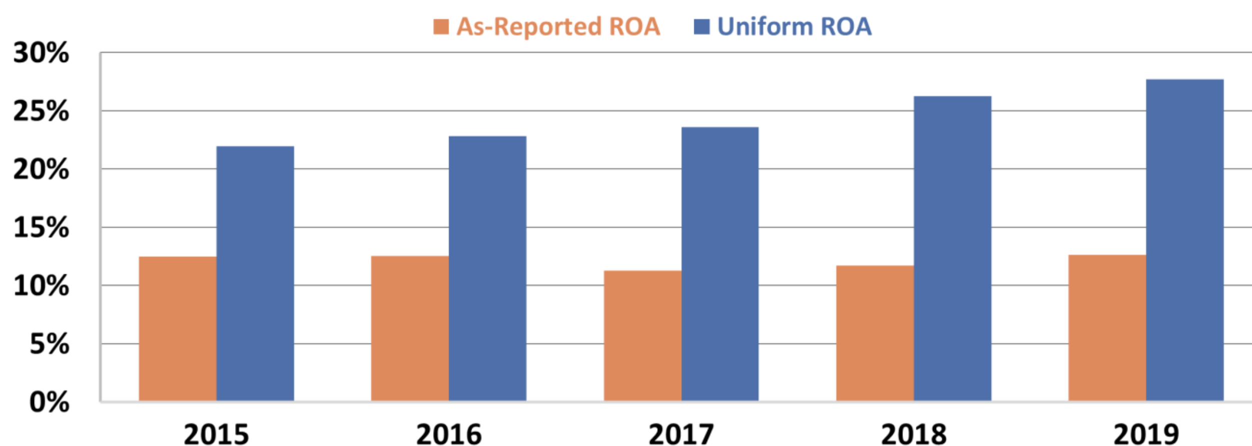
Deficiencies in GAAP/IFRS vis a vis Uniform Accounting

Exhibit 1a



Sources: UAFRS, CaptialIQ

Exhibit 1b

Source: CapitalIQ

Exhibit 1c

EL - The Estée Lauder Companies Inc.	2015	2016	2017	2018	2019
Operating Lease Expense	402.0	442.0	473.0	538.0	583.0
Capitalized Operating Leases	3,232.0	3,553.6	3,752.9	4,268.6	4,625.6
Uniform Earnings	1,340.1	1,471.3	1,630.8	1,956.6	2,257.9
Net Income	1,089.0	1,115.0	1,249.0	1,108.0	1,785.0
% Variance	-18.7%	-24.2%	-23.4%	-43.4%	-20.9%
Uniform Net Assets	6,110.4	6,443.0	6,906.4	7,455.1	8,150.4
Total Assets	8,226.9	9,223.0	11,568.0	12,567.0	13,156.0
% Variance	34.6%	43.1%	67.5%	68.6%	61.4%
Uniform ROA	21.9%	22.8%	23.6%	26.2%	27.7%
As-Reported ROA	12.5%	12.5%	11.3%	11.7%	12.6%
Uniform ROA vs ROA - Variance	9.5%	10.3%	12.3%	14.5%	15.1%

*in USD millions

LH – Laboratory Corp.

LH's Uniform earning power has steadily improved over the past 5+ years, with a brief, yet noticeable drop-off in profitability occurring in 2018 (Exhibit 2a)

Meanwhile, from 2015-2020, the firm's stock price seemed to move in line with Uniform-calculated earnings, with a material increase over that time period, even after significant underperformance in 2018

Meanwhile, GAAP earnings have been weak and deteriorating over the same time period. Clearly, these standards are in total dislocation from the economic reality of the firm's strong performance.

From 2015 up through the start of the pandemic, LH shares saw a material price appreciation, rising from approximately $110/share to over $160/share, an over 50% increase (Exhibit 2b). That said, according to the market, LH appeared to be a firm with declining profitability hovering near the cost-of capital, which would fail to justify the company's stock performance.

However, using Uniform Accounting, we can identify distortions such as a firm's earnings being understated due to a mistreatment of operating leases and their associated interest and amortization expenses. Meanwhile, as also highlighted in the introduction, the firm's lease assets are being mishandled as right-of-use assets and corresponding liabilities, due to the faulty restructuring of lease accounting standards.

According to as-reported metrics, LH saw its Uniform ROA decline from over 7% in 2015 to just 5% in 2019, approaching cost-of-capital levels. Meanwhile, UAFRS-adjusted metrics paint a significantly different picture of LH, where Uniform ROA expanded steadily from 20% to 24% over the same timeframe, excluding outlier underperformance in 2018, justifying the firm's stock price appreciation (Exhibit 2c).

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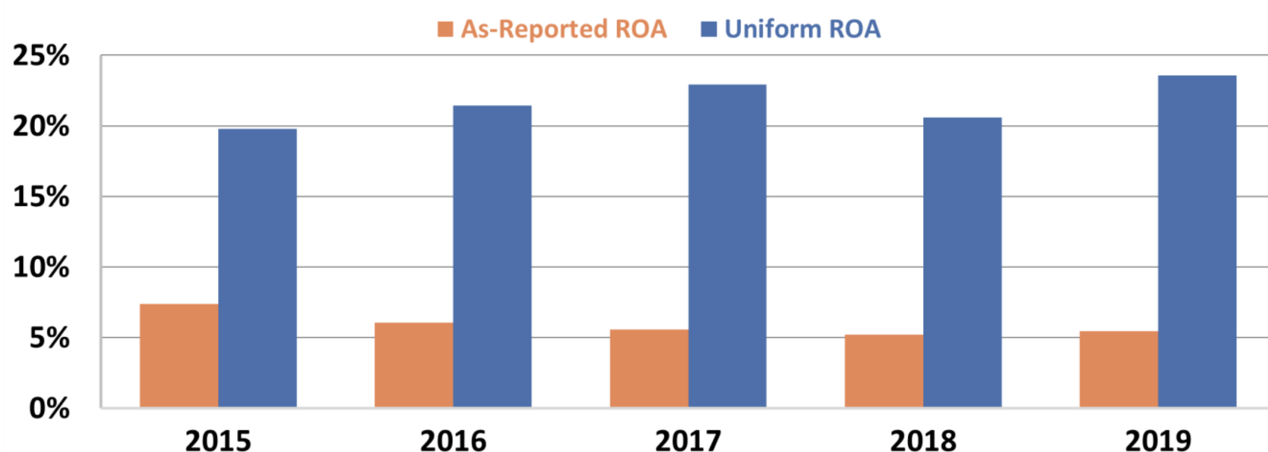
Deficiencies in GAAP/IFRS vis a vis Uniform Accounting

Exhibit 2a



Sources: UAFRS, CaptialIQ

Exhibit 2b

Source: CapitalIQ

Exhibit 2c

LH - Laboratory Corporation of America Holdings	2015	2016	2017	2018	2019
Operating Lease Expense	287.1	291.2	313.8	358.7	255.4
Capitalized Operating Leases	3,166.5	2,874.4	3,107.2	3,810.9	2,870.3
Uniform Earnings	1,012.8	1,104.8	1,213.0	1,214.7	1,344.7
Net Income	437.6	711.8	1,227.1	883.7	823.8
% Variance	-56.8%	-35.6%	1.2%	-27.2%	-38.7%
Uniform Net Assets	5,122.1	5,154.0	5,287.5	5,899.2	5,709.6
Total Assets	14,104.7	14,247.0	16,673.0	16,185.3	18,046.4
% Variance	175.4%	176.4%	215.3%	174.4%	216.1%
Uniform ROA	19.8%	21.4%	22.9%	20.6%	23.6%
As-Reported ROA	7.4%	6.0%	5.6%	5.2%	5.4%
Uniform ROA vs ROA - Variance	12.4%	15.4%	17.4%	15.4%	18.1%

*in USD millions

Deficiencies in GAAP/IFRS vis a vis Uniform Accounting

ORLY – O'Reilly Automotive

ORLY's Uniform earning power has proven to be consistently robust, and has accelerated to stronger levels over the past several years (Exhibit 2a)

The firm's stock price seems to move in line with Uniform-calculated earnings, with material appreciation over the past 5+years

Meanwhile, GAAP earnings have been steadily deteriorating over the same time period. These earnings figures directionally distort the economic reality of the firm's improving performance.

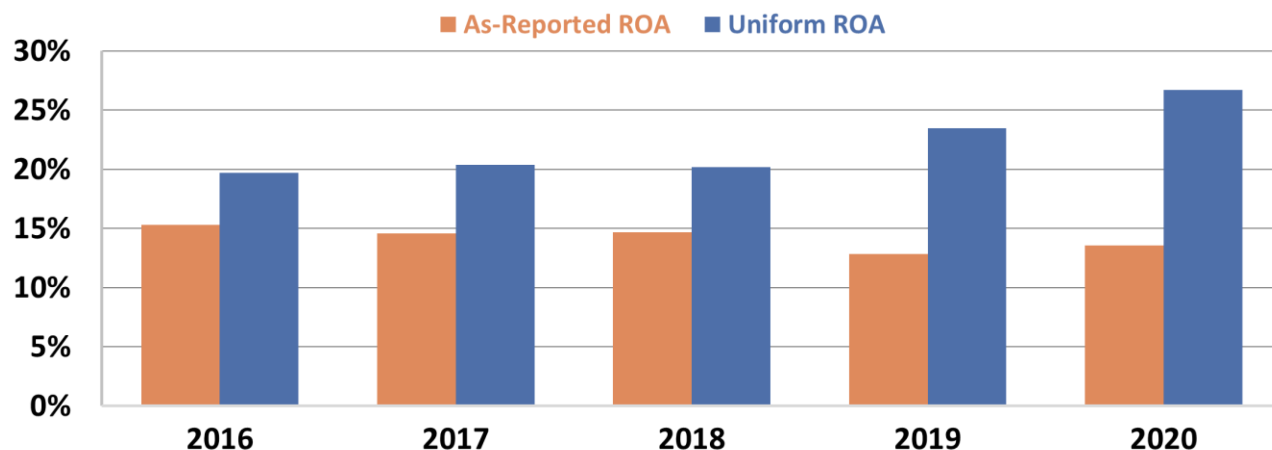
Since 2016, ORLY shares have seen a meaningful stock appreciation, rising from approximately $250/share to over $520/share, an over 100% increase (Exhibit 2b). That said, according to the market, ORLY appears to be a firm that has seen consistently worsening profitability, and not one with improving fundamentals which would warrant this success.

However, using Uniform Accounting, we can identify distortions such as a firm's earnings being understated due to a mistreatment of operating leases and their associated interest and amortization expenses. Meanwhile, as also highlighted in the introduction, the firm's lease assets are being mishandled as right-of-use assets and corresponding liabilities, due to the faulty restructuring of lease accounting standards.

According to as-reported metrics, ORLY saw its Uniform ROA decline from over 15% in 2016 to 14% in 2020. Meanwhile, UAFRS-adjusted metrics paint a different picture of ORLY, where Uniform ROA expanded significantly from 20% to 27% over the same timeframe, suggesting the firm's stock price appreciation may have been justified (Exhibit 2c).

Deficiencies in GAAP/IFRS vis a vis Uniform Accounting

Exhibit 3a



Sources: UAFRS, CaptialIQ

Exhibit 3b

Source: CapitalIQ

Exhibit 3c

ORLY - O'Reilly Automotive, Inc.	2016	2017	2018	2019	2020
Operating Lease Expense	283.3	298.6	317.3	338.7	354.3
Capitalized Operating Leases	3,709.7	4,078.7	4,333.7	4,626.9	4,771.4
Uniform Earnings	1,106.9	1,183.5	1,481.2	1,536.4	1,935.3
Net Income	1,037.7	1,133.8	1,324.5	1,391.0	1,752.3
% Variance	-6.3%	-4.2%	-10.6%	-9.5%	-9.5%
Uniform Net Assets	5,437.3	5,857.9	6,324.2	7,056.7	7,258.1
Total Assets	7,204.19	7,571.89	7,980.79	10,717.16	11,596.64
% Variance	32.5%	29.3%	26.2%	51.9%	59.8%
Uniform ROA	20.4%	20.2%	23.4%	21.8%	26.7%
As-Reported ROA	15.3%	14.6%	14.7%	12.9%	13.6%
Uniform ROA vs ROA - Variance	5.1%	5.6%	8.7%	8.9%	13.1%

*in USD millions

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Definitions

Uniform Net Assets **–** Net Asset’ is calculated as Net Working Capital + Long Term Non-Depreciating Operating Assets (including Land and Non-Depreciating Operating Intangible Assets, excluding Goodwill and other acquisition-related Intangible Assets) + Inflation-Adjusted Net PP&E + Net capitalized R&D + Net Capitalized Leases + Net Depreciating Operating Intangible Assets

Uniform ROA– UAFRS-adjusted ROA is a cleaned up Return on Asset ratio, used to understand the operating fundamentals of the company. UAFRS-adjusted ROA is Earnings’ divided by Asset’.

Uniform Earnings is calculated as Net Income + Special Items + Interest Expense + Depreciation and Amortization Expense + R&D Expense + Rental Expense + Minority Interest Expense + Pension Charges + LIFO to FIFO adjustments + Stock Option Expense + Purchase Accounting Cash Flow Adjustments - Non-Operating (Investment) Income - Asset Life Based Charge on Depreciating Assets. Asset' is Net Asset’, or Net Working Capital + Long-Term Non-Depreciating Operating Assets (including Land and Non-Depreciating Operating Intangible Assets, excluding Goodwill and other acquisition related Intangible Assets) + Inflation Net PP&E + Net Capitalized R&D + Net Capitalized Leases + Net Depreciating Operating Intangible Assets.

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