Puget Sound Business Journal

Guest Opinion

Rule change could put leases on balance sheets

Puget Sound Business Journal (Seattle) - June 1, 2007
by Paul Suzman and Roger Clark

The Financial Accounting Standards Board doesn't often set one's pulse racing. But a working group assembled by FASB and the International Accounting Standards Board began in February considering rule changes that could weaken many company balance sheets and roil the office-lease and development market.

Under current rules, companies are not required to list the future rent for their leased space or equipment among items in their balance sheet liabilities. The information is typically in a footnote to the financial statements.

But the rule makers are considering whether the transparency of corporate financial reporting has been seriously compromised by "off-balance-sheet" lease obligations, as many investors and accounting experts suggest.

The change under consideration likely would require some discounted value of lease payments (perhaps a third to half of total lease payments over the term of the lease) to be listed with other liabilities. The amount will likely depend upon applicable interest rates, term of payments, and the ultimate rules applied to leases.

How could this impact your company? For public and private companies, and especially for retailers, this could materially increase recorded assets and liabilities. That, in turn, would affect companies' working capital, debt and key financial ratios.

The amount of adjustment is staggering. In 2005, the Securities and Exchange Commission estimated that the undiscounted value of future real estate lease payments among public companies was more than $1.25 trillion. The figure doesn't include the lease obligations of private companies.

What is behind the review? There is a general perception that existing lease accounting rules permit assets (and the related financing liabilities) to be kept off the books, regardless of economic substance, as long as the form of the transaction stays within the "bright lines" of the rules. Those rules and their interpretations have become increasingly complex. Only specialists can hope to navigate such complexity and many have failed. This may be partly responsible for erroneous lease accounting that has led over 100 companies including Burlington Coat Factory, Denny's, Gap Inc., Iron Mountain, Krispy Kreme, Shoe Pavilion and Wendy's to restate their earnings

The arcane "magic" that allows both the asset and the liability to "disappear" begins by arguing that property, plant and equipment must be "owned" to be an asset. If there is no asset, then there can be no liability. Because existing leasing rules allow this sleight of hand, a great many financing transactions can be structured so that the assets and liabilities are off the balance sheet.

Corporations that choose to own their facilities typically are seeking long-term stability. Well located real estate is typically a solidly appreciating asset for the owner. However, a joint Baruch College and Yale study compared annual returns of real estate with those of 15 different "paper" investments, including stocks, from 1978 to 2004. Commercial properties' annualized returns were outperformed by the Standard & Poor's 9.5 percent versus 13.4 percent!

There are many arguments as to the benefits or otherwise of being an owner versus a tenant. However, should rule changes result in real estate lease obligations being moved onto the balance sheet, this might drive many corporations that currently employ long-term leases to assume shorter lease obligations with extension options or choose to employ working capital for real estate acquisition. This could cost companies the flexiblity to move, expand or contract their space and hamper their ability to secure choice locations, which is especially crucial for retailers.

Might this have a dampening effect on economic growth? It well could lead to financing problems for developers. Most lending institutions currently require long-term preleasing from credit tenants in order to finance developers' buildings. So the final decision on FASB 13 could have a considerable impact on both corporate lessees, corporate real estate providers and equipment lessors.

Strong support for lease accounting changes is coming from chief financial officers. When asked in a national survey conducted by Grant Thornton LLP, "Should lease accounting rules be revised to give investors more transparency?" 63 percent agreed.

These are slow processes. Expect preliminary comments from FASB in the second quarter of 2008. So there's time to see it coming. But if your business entails leasing space and other assets as lessee or lessor, you should understand the implications and start getting involved now. Or make your thoughts known to FASB.

PAUL SUZMAN is managing director of OfficeLease which, since 1981, has represented the interests of tenants and buyers of commercial real estate in the greater Seattle area. ROGER CLARK is managing partner of the Seattle and Portland offices of Grant Thornton LLP, the U.S. member firm of Grant Thornton International, one of the leading accounting, tax and business advisory organizations.