Will an accounting rule change hurt leasing?
DON JACOBSON, Special to the Star Tribune

Big national retailers, bank chains and other publicly traded companies are among the most dependable of commercial real estate tenants, and are especially coveted during times of economic stress such as these.

But concerns have arisen this year that proposed new accounting standards affecting how they report their commercial leases to investors could adversely affect their appetite for real estate at a time when they're needed most.

The U.S. standards on how companies account for their real estate leases is under review by the Financial Accounting Standards Board (FASB), which is attempting to bring its generally accepted accounting principles, or GAAP, in line with international standards. The idea is to provide more transparency for worldwide investors who feel the lease expenses of U.S. companies aren't being properly recognized in their financial statements as they are elsewhere in the world.

The upshot is that as early as 2013, U.S. companies may be required to move data about their leases from the footnotes of their statements onto the balance sheet, to be accounted for as assets and liabilities -- in essence, asking companies to account for their leases as capital expenses, much as they do now when they buy real estate and make other kinds of purchases.

Instead of being able to account for rent paid as off-balance-sheet expenses as is now the case, the proposed new rule would require that future obligations implicit under a 10-year lease, for example, be initially counted as a liability, then depreciated in subsequent years over the term of the lease.

The proposed change would place more than $1 trillion in commercial real estate leases onto the balance sheets of publicly traded companies, the U.S. Securities Exchange Commission has estimated, and that in turn prompted widespread concerns that these big tenants would rethink their leasing strategies -- perhaps dealing a blow to a fragile recovery by insisting on shorter leases, turning down renewal options and buying instead of renting as a way of keeping their balance sheets looking attractive.

After some initial panic in the real estate industry when the FASB first proposed the changes earlier this year, brokers and accountants have since had a chance to digest what the rules might mean if they are enacted and have become much more sanguine. Many now believe the actual effect on net lease demand would be marginal.

One reason for that, said John Lawson, a shareholder in the Minneapolis-based accounting firm Schechter Dokken Kanter, is that despite possible changes to balance sheets, corporate cash flows wouldn't be affected -- which is literally the bottom line for investors.

"This doesn't change the economics," Lawson said. "At first this may cause some market confusion among investors, business owners, and those that finance businesses. However, since everyone is required to change this, everyone will be in the same boat and the confusion will subside over time."

One of the concerns with the proposed change is the "front-ending" of lease expenses.

For instance, when a company signs a commercial lease, the liabilities related to the deal will be greater at the start of its term -- for instance, the imputed interest paid on such leases is greater in the beginning.

The proposal would also change financial ratios, such as the debt-to-equity ratio.

But, Lawson said, that won't make any difference to bankers when a company is looking for financing because its cash flows aren't affected. He used an example of two retailers in adjoining storefronts -- one with two years remaining on its lease and one with four years.

"The banker, who lends to both companies, sees both financials. He shouldn't look at the retailer with four years left any differently than the one with two years left, even though the one with four years has about twice as much in its lease liability," Lawson said.

Dennis Panzer, managing principal of Cassidy Turley Real Estate Services' Twin Cities office, said he, too, doubts that the FASB proposal, if implemented, will much reduce the appetite of the big, national tenants when it comes to signing leases.

After an adjustment period, he predicted, the new accounting method won't end up scaring companies into reducing their lease portfolios.

"There's a small chance there will be some cases where you'll find some people who will say, 'OK, I'm going to buy now instead of lease,' and that may impact some of the bigger users' view of the world," he said. "It's also possible it may impact the length of lease terms and the way that renewal options get negotiated."

But, he added, he's also convinced that businesses will continue to do what's right for their operations, and if that means signing long-term leases even though they'd have to be recorded as liabilities, that's what they'll do.

"I've heard CFOs say, 'Look, we're going to run our business the right way to run our business. Accounting doesn't run the business.'

"Everybody will get their heads around the reporting part of it and investors will be able to use the figures to make accurate comparisons," Panzer said.

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