

**FINANCE**

Corporate leases may draw more scrutiny

Proposed accounting rule changes could affect balance sheets

By [STAN BULLARD](#)

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Just what corporate users of real estate, property owners and realty service firms need: another shift in the way companies, primarily public ones, book lease transactions that may roil an already ailing industry.

This time the challenge comes not from the economy or lenders, but rather from the Financial Accounting Standards Board, a nonprofit group that sets accounting standards.

FASB is considering new standards for financial statements that would move the cost of operating leases — and even options to extend leases — onto public company balance sheets from a disclosure in the footnotes.

The new rules currently are in a public comment period. If the board adopts them next year — which it is largely expected to do — they would become effective two years later, or in 2013.

However, decisions companies make now may have an immediate impact when the rules go into effect in 2013, because there will be no provision to exempt older leases by grandfathering them in.

Local experts are divided on the results of the change, but at a minimum it will mean leasing as a means for handling real estate and equipment will be viewed differently. Some feel the impact will be more dramatic given that the larger a company is, and the more property it leases, the more liability it will add to its balance sheet.

Many experts, such as Bob Nosal, managing director of Grubb & Ellis Co.'s Cleveland office, and David Browning, managing director of CB Richard Ellis' Cleveland office, wonder if the shift will mean some companies will be more inclined to own properties than lease, as they have in the recent past.

Norm Gutmacher, a partner in the real estate group at Benesch Friedlander Coplan & Aronoff law firm, said he views the rules as likely to go into effect and believes companies should start factoring them into their decisions now.

"Be an ostrich; stick your head in the sand. But remember where ostriches get shot," Mr. Gutmacher said. "I think it will have a dramatic effect on planning, on property decisions and on balance sheets — and that is what it is

intended to do.”

Paradigm shift

The rule would require compliance from companies that follow generally accepted accounting principles, which includes most public companies, public company wannabes and some smaller companies that need to follow it to adhere with lender requirements.

That means companies would have to book the entire cost of a lease as a liability at the time the lease is signed, Mr. Gutmacher said, as well as options. Lease costs rapidly reach the millions of dollars for a significant amount of space or locations for large companies with multiple leased locations.

The change removes one of the benefits of leasing compared to ownership, Mr. Gutmacher said, because leases would have to be factored in as liabilities up front, just as purchasing a property is today.

“This will change the paradigm,” Mr. Gutmacher said. “It's a change in the way people have been doing it for longer than I have been practicing law, since the 1970s.”

However, others are less Cassandra-like. John Funk, director of real estate services at the Maloney + Novotny accounting firm of Cleveland, calls the measure “a game-changer as far as financial presentation goes. But do the accounting rules become the tail wagging the dog?”

“I think not, particularly for middle-market companies. They will still choose what basis they use for financial reporting. Sophisticated investors (in public companies) already know how to calculate this from the footnotes. I do not think it will change the way my clients handle their real estate and decide whether to buy or lease. It's just a different financial reporting mechanism.”

However, some ideas for how the new rules will affect corporate real estate and the industry that serves it are afoot.

For one, companies may try to shorten lease terms in order to reduce the size of the liability they must disclose. However, Mr. Gutmacher said, companies that want a developer to build and lease a building to them will confront the requirement that lenders want long-term leases, in some cases 20 years, to secure construction loans.

“Some buildings may not be built, at least initially,” Mr. Gutmacher said. “There will be a period of chaos followed by realignment.”

Ripple effects

However, Michael Cantor, a principal of Allegro Realty Advisors of Cleveland, which describes itself as a real estate consultant for corporations, said a shorter lease means tenants would have to pay for more of the expenses for outfitting their space over a shorter term, making for higher leases.

He believes the tax and market implications will balance one another out.

Mr. Cantor said the most profound impact will be felt by companies that lease multiple locations in order to free capital for operations. However, he said, the own-versus-lease analysis will be different for each company.

“I've had companies that lease for flexibility, which you do not get with ownership,” Mr. Cantor said.

He said he also has seen firms sell properties because they did not need the space and did not want to take the risk of holding empty space.

Another thing that companies will need to watch is whether incorporating leases into their books as liabilities will put them out of compliance with bank-loan covenants, Mr. Gutmacher said. Lenders may not be overly concerned about a technical violation, he said, but it would give banks more negotiating power over borrowers.

The new FASB rules also will mean a lot for companies that lease equipment, for leases less than a year will have to be included as liabilities rather than expenses.

Construction companies are heavy users of leased equipment because they may not need it all the time, or only for a specific project.

Aaron Cook of Meaden & Moore, an accounting and business consulting firm in Cleveland, said the short-term provision may get jerked from the final rule, but if it is not, it will hit the weak construction business hard. He said even small contractors would feel its bite, if only because of more paperwork.

Niche killer?

The biggest impact on the real estate business may be hampering a niche, as making leasing less attractive will reduce the allure of companies selling buildings and leasing them back to raise cash.

"That's the segment I believe will be impacted the most," Mr. Cantor said. In northern Ohio, sale-leaseback deals typically are arising for out-of-town based retailers, restaurateurs and warehouse operators who sell off properties here.

Given that most companies are preoccupied with surviving the downturn and making a profit and most real estate operators are focused on keeping properties occupied and loans current, many experts agree the timing for the new FASB rule could not be worse.

"Whether it deserves it or not, the last thing real estate needs is another potential shift in how it does business," Mr. Gutmacher said.

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