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Out of the Footnotes, Into the Spotlight

By JACQUELINE DOHERTY | MORE ARTICLES BY AUTHOR

FASB has proposed a rule change that would reclassify operating leases as debt. What it would mean for companies and investors.

Investors, get out your green eyeshades. Accounting for leases has become a hot topic in the finance departments of major U.S. corporations, and soon could become one on Wall Street as well. The Financial Accounting Standards Board, or FASB, has proposed taking operating leases out of the footnotes of financial statements and placing them squarely on corporate balance sheets, a change that would increase debt levels and, in the near term, reduce reported earnings at many large corporations.

It also might alter return on assets and debt-to-equity ratios, says Dwayne Shackelford, principal at Huntley, Mullaney, Spargo & Sullivan, a real-estate and financial-restructuring firm. Final rules are expected from FASB by year end, and could affect companies beginning in 2013.

Collectively, companies in the Standard & Poor's 500 have at least $549 billion in operating leases, estimates David Zion, an accounting analyst at Credit Suisse. Under current FASB rules, a company can classify a lease as operating if the lease period is significantly less than the useful life of the asset in question and the lessor retains ownership rights and risks. Costs associated with such leases are treated as operating expenses. Capital leases, in contrast, cover long-term use and confer ownership risks and benefits. They are treated as debt. FASB's proposal would consider the present value of all operating-lease payments and financing costs as debt.

THE DEBATE OVER LEASE ACCOUNTING began in 2006, and is part of a larger push both to increase financial transparency and make U.S. and international accounting standards more uniform. Proponents of FASB's proposal, such as Christopher "Kit"

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Menkin, editor and publisher of Leasing News, say the rule change is necessary to increase disclosure to investors about companies' future obligations. Critics, such as **FedEx** (ticker: FDX) and **PepsiCo** (PEP), fear that aspects of the proposed rule will be too costly and time-consuming to implement.

Companies as diverse as **General Electric** (GE), **J.C. Penney** (JCP) and **JPMorgan Chase** (JPM) have weighed in on the change in letters to FASB. Many smaller businesses, which typically capitalize their leases, support the change, Menkin says.

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Chris Keane (FedEx); Daniel Acker/Bloomberg News

Some analysts, including those at rating agencies, long have considered operating-lease obligations in calculating a company's total debt. HOLT, a unit of Credit Suisse, does so to facilitate comparisons among companies with operating leases, capital leases and owned assets.

Lease Is More

Under current accounting rules, FedEx has far less debt than rival UPS. If a change in FASB rules requires the companies to add leases to their balance sheets, reported debt at FedEx will balloon.

	FedEx*	UPS**
Total debt (bil)	$1.93	$10.85
Debt/market capitalization	7%	15%
After inclusion of operating leases		
Debt + est. operating leases (bil)	$16.28	$15.96
Debt + est. operating leases/market cap	56%	22%

*Debt and operating leases as of 5/31/2010. **Debt and operating leases as of 12/31/2010. Market capitalization as of May 31. *Source: Credit Suisse HOLT ValueSearch*

To understand the impact of the possible rule change, consider the balance sheets of FedEx and **United Parcel Service** (UPS). FedEx finished its latest reported fiscal year (ended May 31, 2010) with $1.93 billion of debt, equal to 7% of its market capitalization. UPS, whose fiscal year ended in December, had $10.8 billion of debt, equal to 15% of its market cap, according to HOLT. If both companies were forced to add operating leases to their balance sheets, however, total debt at FedEx would jump to $16.3 billion, or 56% of the company's market value. Debt at UPS would edge up to $16 billion, or 22% of its market cap.

"Although they are regarded as close operating peers, the difference between leasing and owning assets results in significant comparability issues if not properly adjusted," states a HOLT report.

A UPS representative said the company couldn't quantify the precise impact of the proposed change until the final standard is released. "The proposed accounting standard, if adopted, will not change our view on leasing versus buying an asset, since we don't lease assets solely for accounting purposes," the spokesperson said in an e-mail to *Barron's*. "We only lease assets when the underlying economics of the lease transaction justify doing so, and/or when we plan to use an asset for a relatively short period of time."

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FedEx declined to comment, citing a quiet period prior to the release of its fiscal fourth-quarter earnings. In its letter to FASB, FedEx noted it has 14,000 leases with total future commitments in excess of $14 billion.

The Bottom Line

A proposed FASB rule could add substantial debt to corporate balance sheets and alter key financial metrics, such as return on assets and debt-to-equity ratios.

"We support the fundamental proposal... to reflect the obligation associated with long-term lease commitments in the balance sheet," the letter states. But the company noted some lease payments are determined by future events, such as sales levels that are difficult to predict, and could be subject to frequent revision. FedEx also indicated it would like more specificity about when lease liability needs to be reestimated. It doesn't believe leases of less than a year's duration should be included in the rule change.

Under the proposed rules, a company would book an operating lease as a liability, and book an asset to reflect its ability to access the item being leased. But the asset would be less than the debt incurred, as it wouldn't include financing expense or the residual value of the item when it is returned at the end of the lease. Similarly, rent expense on the income statement would be replaced with amortization and interest charges, which could reduce earnings, especially in the early years of the lease, though inflate them in later years.

Even if FASB implements new lease-accounting rules, investors might choose to ignore lease-related debt, just as they do stock-option expenses at some technology companies. Either way, they won't have to muck around in the footnotes any more to get a clear picture of a company's future financial obligations.

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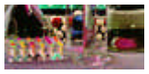

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