The Biggest Threat to Retailers' Earnings

By Bill Bosco

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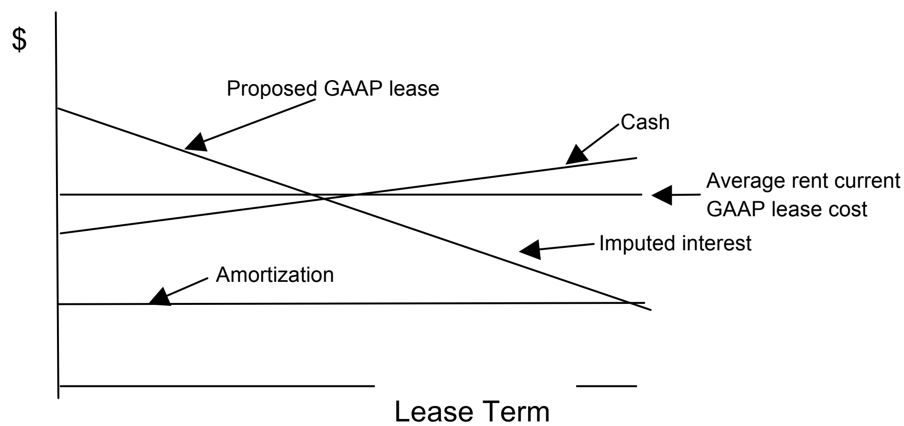
Is the economy the biggest threat to earnings of US retail companies or is it the FASB (Financial Accounting Standards Board)? I think not enough retail companies are aware that the biggest threat may just be a proposed lease accounting rule. The FASB and the IASB (International Accounting Standards Board) have issued an Exposure Draft (ED) of proposed new rules for lease accounting (ED available on www.fasb.org). Every retail company that leases real estate must read the Leases Project ED and understand its implications. The FASB is now accepting comments so there is a process available to change the proposal before it becomes a generally accepted accounting principle (GAAP).

Summary of Current vs. Proposed Lease Accounting Rules:

Issue	**Current GAAP per FAS 13**	**Proposed GAAP per Lease Project ED**
Operating lease accounting	Off balance sheet with straight lined average rent expense in the P&L	Right to use asset is an intangible asset and obligation to pay rent is a liability, both on balance sheet. P&L lease expense is amortization of the asset plus imputed interest on the liability creating a front ended cost pattern.
Definition of lease term	Base term plus bargain renewals	Base term plus likely renewals (likely is a much lower threshold and it means more lease payments are capitalized)
Definition of lease payments	Base term rents plus bargain renewals	Base term rents, bargain renewals, likely renewals, contingent rents (Ca& sales based percentage rents) and likely payments under residual guarantees are all considered lease payments meaning higher amounts capitalized
Contingent rents	Cash basis accounting when they occur (back ended)	Capitalized and included in front ended lease costs

The Leases Project is intended to capitalize operating lease obligations that are currently off balance sheet as analysts adjust financials by capitalizing operating lease obligations when they analyze the credit of a company. The current accounting rule (Financial Accounting Standard 13) requires only off balance sheet footnote disclosure of future operating lease obligations. The ED does much more than merely capitalize leases as the analysts do. The proposed rule capitalizes estimated renewal and estimated percentage rents; so much more is capitalized than expected. Many people believe that estimated renewals and percentage rents do not meet the definition of a liability so they should not be capitalized. The ED requires that the estimates be reviewed and adjusted when there is a material change (this could well mean monthly adjustments). Also the FASB decided that average rent expense is not lease expense but rather the ED proposes that amortization of the capitalized asset and imputed interest on the capitalized liability are the reported P&L cost of the lease. This results in a front ended lease cost pattern which many people believe does not correctly reflect the economic cost pattern of a lease. The front ended pattern causes the increased lease cost to accumulate until the midpoint of the lease term at which point it turns around so that lease costs are lower in the second half of the lease. Given Wall Street’s “what have you done for me lately” philosophy, it is not good to have better earnings in the future while you have lower earnings now. The front ended pattern is best illustrated as follows:



The front ending gets larger the longer th s follows:

The Effect of Front Ending Lease Costs	
Lease Term	**First Year Increase in Lease Cost – Proposed vs. Current GAAP**
5 Years	12%
10 Years	21%
15 Years	26%
20 Years	28%

I did some estimates of the impact of the ED's lease cost pattern versus current GAAP rent expense for several of the largest US retailers. I used footnoted future operating lease payments from their 2008 10K annual reports and the lease capitalization model that S&P uses (the model is available on my website www.leasing-101.com). I know the results are understated compared to the ED's capitalization model as it does not capture estimated renewals and percentage rents.

Impact of Front-Ended Lease Cost for Selected Large US Retail Companies (in $ Millions)				
Company	**Cumulative increase in lease cost vs. current GAAP to turn around point**	**Year of turn around**	**1st yr increase in cost vs. current GAAP**	**% in excess of current GAAP in 1st year**
Walgreen's	***2,664***	10	***456***	***23***
CVS	1,500	9	330	19
Wal-Mart	838	8	194	17
Home Depot	581	9	125	16
Target	487	***15***	50	21
Sears	374	6	118	14
Kroger	323	6	112	14
Best Buy	275	6	127	12

The above amounts are huge but the actual numbers will be greater. Looking at Walgreen's, if the impact is three times the above; their pretax earnings will drop by 50% in the first year under the proposed rules. It's not too late to change the direction of the rules and there are alternative views that have sound basis, but it if you do not comment to the FASB, the ED will be reality.

About the Author:

Bill Bosco is the President of Leasing 101, a lease consulting company. Bill has over 35 years experience in the leasing industry. His areas of expertise are accounting, tax, financial analysis, structuring, pricing and training. He has been on the Equipment Finance and Leasing

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