10 Land Mines From New FASB Rule For Off-Balance Sheet Debt

Yesterday, the Financial Accounting Standards Board (FASB) voted to update standards on operating lease accounting that would force companies to record as much as $2 trillion worth of lease obligations on their balance sheets.

Off-balance sheet operating leases as a substitute for debt has been an issue since the SEC asked the FASB to update the rules over a decade ago. We've been closely following this topic for many years. Our models have always made the adjustment to put off-balance sheet debt back on the balance sheet to get a better sense of a company's obligations and to hold management accountable for the capital used in the business.

For investors who haven't been following this issue, however, the new rules may come as quite a shock once they're enacted in 2018. As Figure 1 shows, the new rules could potentially add tens of billions in obligations to some company's balance sheets. The impact for some companies will be more than 10 times their entire market cap!

Figure 1: Here Are the Land Mines For Off-Balance Sheet Debt

Ticker	Name	Off-Balance Sheet Debt (in $mm)	% of Market Cap	Stock Rating
Largest Total Amount Of Off-Balance Sheet Debt				
WBA	Walgreens	$26,508	29%	Dangerous
T	AT&T	$24,263	14%	Dangerous
CVS	CVS Health	$19,508	18%	Neutral
UAL	United Continental Holdings	$14,274	62%	Attractive
WMT	Wal-Mart	$13,346	7%	Attractive
Largest Amount Of Off-Balance Sheet Debt As A % Of Market Cap				
PSUN	Pacific Sunwear	$272	1,183%	Dangerous
KWKAQ	Quicksilver Resources	$21	1,164%	Neutral
APP	American Apparel	$192	993%	Dangerous
FVE	Five Star Quality Care	$1,502	873%	Dangerous
CLUB	Town Sports International	$442	856%	Neutral

Sources: New Constructs, LLC and company filings.

Certain industries, such as retailers, telecoms, and airlines will be especially affected. The use of off-balance sheet operating leases for airlines is so common that the former chairman of the International Accounting Standards Board, FASB's equivalent, famously joked that he wants to fly on a plane that is carried on the airline's balance sheet before he dies.

Apples-to-Apples Comparisons Will Get Tougher

Some might argue that this change to accounting rules is not all that important. After all, the information on operating leases is already disclosed in the footnotes, so what does it matter if it's just put on the balance sheet instead?

That's the argument made by certain companies, who say the new rule would "change the presentation of this information without giving investors and analysts significant new information beyond what we already provide."

That argument falls apart when you learn that AT&T, along with other big users of operating leases such as Delta, have vigorously opposed the new rules. If it's just changing the presentation without materially affecting anything, then why do they care?

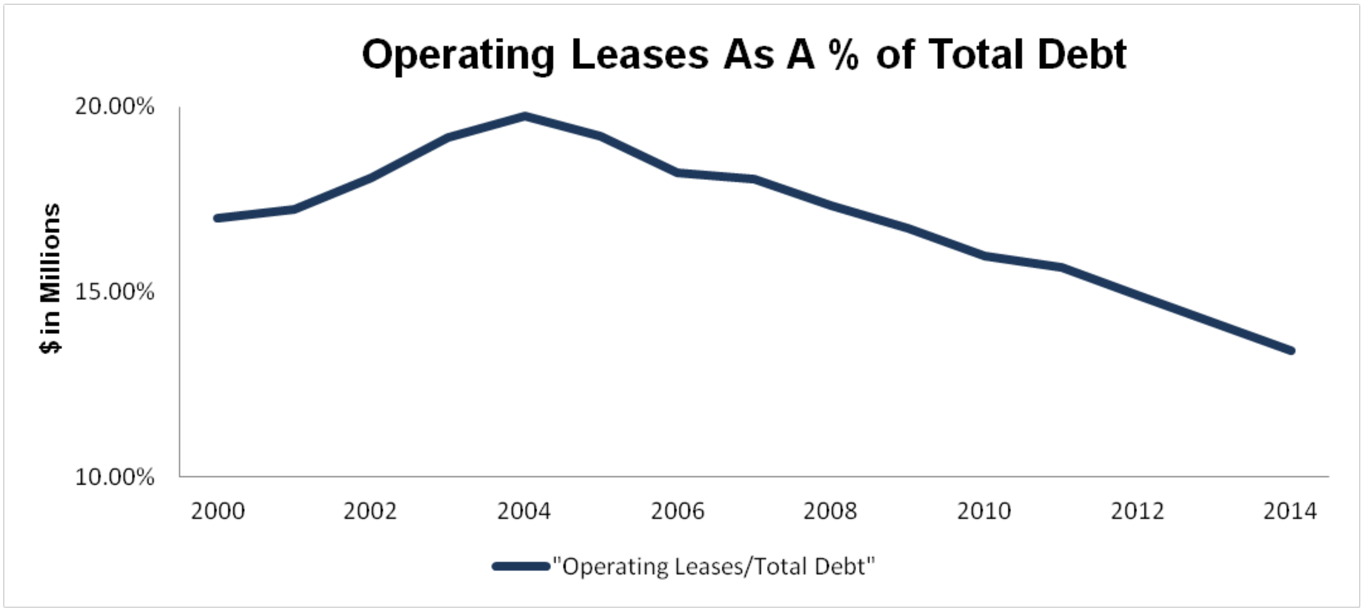
The truth, of course, is that it does matter, because a lot of investors do not have the time or expertise needed to make the proper adjustments for off-balance sheet debt. Buried deep in the footnotes of the annual 10-K, this item is easily missed by those who don't spend a lot of time reading financial filings.

All these obligations hitting the balance sheet will create a one-time shock, but it will also become a persistent problem for investors that will have to go back and adjust old data to make it comparable to the new rules. Models quickly become useless if they don't follow the same accounting rules year-by-year and company-by-company.

Continuing A Trend That Lessens the Impact

This issue is not just relevant for 2018, it's already affecting investors right now. Figure 2 shows that the relative value of off-balance sheet debt has been declining ever since the first discussions of adding operating leases to the balance sheet began in 2005. That year, hundreds of companies were forced to restate their financials due to improper lease accounting.

Figure 2: Companies Are Preparing For the Rule Change



Sources: New Constructs, LLC and company filings.

For roughly a decade, companies have been increasingly capitalizing leases on the balance sheet or shifting towards taking on debt and purchasing new property, plant, and equipment. This trend will only accelerate as 2018 approaches and companies prepare to comply with the new standards.

Not only does this shift impact the balance sheet, it flows into the income statement by impacting depreciation, amortization, and interest expense.

If they haven't already, investors need to be using models that account for off-balance sheet debt so they can get a comparable and accurate picture of every company's invested capital and future obligations.

Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

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