

Operating Lease

The most common form of off-balance-sheet financing is through an operating lease. It works as follows. A firm enters into a contract to lease property from another firm. The lease is for a very long time, or (at least) covers most of the useful life of the property. A lease structured this way is essentially borrowing money and buying the property. However, because it is a lease, the borrowed money (i.e. the debt) is not shown on the balance sheet.

Theoretically, Generally Accepted Accounting Principles (GAAP) are supposed to prevent this practice. Rules exist that are supposed to distinguish between leases that are essentially debt (capital leases) and leases that are not debt (operating leases).

But creative accountants can read GAAP rules also, and they are constantly at work figuring out legal ways around them. Many accountants can structure leases that are technically operating leases, but practically capital leases. GAAP rules do not eliminate the practice of lease abuse altogether; they just reduce them.

Fortunately, there is a simple solution to this problem. Read the footnotes. Firms are required to disclose the future payments on even long-term operating leases. If you know these payments, you can at least get some idea how large the problem might be.