



6 Things You Need to Know About New Accounting Rules for Leases

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Ready or not, CFOs, the new FASB Rules for lease accounting will go into effect soon. They'll make firms with significant leases for commercial space look asset-rich but also heavily in debt.

FASB is the Financial Accounting Standards Board and here are six important things you need to know:

What is the change?

The new FASB accounting rules will require operating leases, such as office and industrial space leases, to be recorded on a company's balance sheet and income statement (P&L). Previously, only capital leases, which essentially are purchases, had to be recorded on your financial statements.

Why is this change being made?

It's being done to provide transparency for investors, shareholders, banks, lenders and regulators to make sound judgments about a company's financial condition. US and international accounting boards, respectively known as FASB and IASB, have already agreed to these accounting changes. Trillions of dollars in lease obligations will hit corporate and even small business' financial statements.

Do the total value of the lease (and renewal options) need to be added to your balance sheet?

If your lease is longer than 12 months, or if the combined lease plus option to renew is "reasonably certain" to be exercised are longer than 12 months, then the Tenant must record the entire total value on its balance sheet at the start of the lease term.

When will the new FASB Rules take effect?

The new FASB Rules party begins on January 1, 2019, for public companies and January 1, 2020, for private companies. However, in both cases, the look-back period for existing leases is two (2) years prior to the effective date. For public companies, that impact begins this month (January 2017).

What will the impact be?

As a result of this additional indebtedness, some companies will immediately exceed debt-to-equity ratios required by their bank/lender loan agreements. For example, a Tenant that leases 20,000 SF of office space for 10 years at an average base rent of \$30.00/SF will add \$6,000,000 in debt to its balance sheet (20,000 SF x 10 years x \$30.00/SF/year).

Are shorter-term leases the best defensive strategy for all Tenants?

The shorter the lease term and the renewal options combined, the smaller the liability to be recorded on a company's balance sheet. Therefore, a shorter-term office lease will be a good strategy for some companies to pursue. For others, though, a shorter-term lease will not be prudent because one or more of the following critical factors will outweigh the benefits:

- A. **Tenant Improvement ("TI") Costs** - TI Costs paid by the Tenant must be amortized into its lease and put onto its balance sheet. Using the same 20,000 SF Tenant above, assume that it incurred \$5.00/SF of additional construction costs (above its TI Allowance) to amortize into its rent. At \$100,000 in total, that would be \$10,000/year on a 10-year lease term but \$33,333/year on a 3-year term.
- B. **Rising Rental Rates** - In Denver/Boulder over the last 10 years, rental rates have risen 34% for Industrial and 28% for Office space. Tenants that locked in 7 to 10-year leases are likely paying far below current market rental rates today. If these were sizable Tenants that had instead entered into multiple 3-year lease terms over the same period, then they would have paid hundreds of thousands or even millions of dollars in higher rents. (Note that every dollar paid in higher rents comes right out of a Tenant's net profits.) As a hot US market, Office and Industrial rents in Denver/Boulder are likely to escalate even higher over time.
- C. **Risk Management** - A Tenant entering into shorter-term office or industrial lease, without renewal options, opens the door to the possibility of being forced out of its spaces by another tenant willing to sign a larger and/or longer-term lease. This could be particularly true in hot Office and Industrial Submarkets where vacancies are shockingly low.

ABOUT ITRA MACLAURIN WILLIAMS

ITRA MacLaurin Williams is the ITRA Global office in Denver/Boulder, Colorado USA. ITRA Global is comprised of highly experienced real estate professionals that specialize in representing Commercial Tenants and Buyers to lease, acquire and dispose of Office and Industrial space.

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