Six Things You Need to Know About the New Accounting Rules

Ready or not, the new lease accounting rules will soon take effect and will result in companies with significant leases appearing asset rich but also heavily indebted. Here are six things you need to know.

What is the change? The new accounting rules will require operating leases, such as office leases, to be recorded on the balance sheet and income statement (P&L). In the past, only capital leases, which are essentially purchases, were recorded.

Why is this change being made? To provide transparency in order for investors, banks, regulators, and other stakeholders to make sound judgments about a company's financial condition. The changes have been made by the domestic and international accounting boards, commonly known as FASB and IASB respectively, and are estimated to add trillions of dollars in lease obligations onto balance sheets.

Does the total value of the lease need to be added to the balance sheet? If the lease is longer than twelve months, or the combined lease and option to renew which the tenant is "reasonably certain" to exercise is longer than twelve months, then the tenant must record the total value at the start of the lease.

When will the new rules take effect? January, 2019 for public companies, and January, 2020 for private companies. However, in each instance, the look back period of existing leases is two years prior to the effective date. For public companies, that impact is this month (January, 2017).

What will the impact be? As a result of this additional indebtedness, some companies will exceed the debt-to-equity ratio required by their bank loan agreements. For example, a tenant which leases 20,000 SF of office space for 10 years at an average base rent of $30 per square foot will add $6,000,000 in debt to its balance sheet (20,000 SF x 10 years x $30/SF/year).

Are shorter term leases the best strategy for all tenants? The shorter the lease term, the smaller the liability recognized on a company's balance sheet. Therefore, a shorter-term office lease will be a good strategy for some companies. For others, a shorter-term lease is not advisable because the benefits will be offset by one or more of the following:

A. High construction costs that must be amortized into the lease. For example, using the illustration of 20,000 SF above, let's assume the tenant had additional construction costs (above the Tenant Improvement Allowance) to amortize into the rental of $10,000 per year in a ten-year term and $33,333 per year in a three-year term;

B. Rising rental rates. In Nashville, rental rates have risen each year for the past ten years (escalated increases in the last 4 years due to the popularity of the market), and those who locked in ten year leases coming due over the next two to three years are enjoying rental rates far below market. If these were sizable tenants that had instead entered into multiple three year terms, they would have paid hundreds of thousands of dollars more over the same period as rental rates increased. If history is an indicator, rental rates in Nashville will continue to increase for the foreseeable future; and

C. Risk management. Companies entering into shorter term office leases open the door to the possibility of being forced out of their space by another tenant willing to sign a long-term lease, particularly with the supply of available office space in several office submarkets having greater demand than availability in the Nashville area.

All information herein is from sources deemed reliable, but no warranty, expressed or implied, is made.

A Collaboration between Mylinda Vick, Cherry & Associates
ITRA Global Nashville, TN and
Carrie Holstead, ITRA Global Pittsburgh, Pennsylvania, USA

About Cherry & Associates / ITRA Global

Cherry & Associates is the Nashville office of ITRA Global, an organization of real estate professionals specializing in representing commercial tenants and buyers in the leasing, acquisition and disposition of office, industrial and retail facilities. With coverage in major markets around the world, ITRA Global is one of the largest organizations dedicated to representing tenants and occupiers of commercial real estate. Clients benefit by having an experienced professional as their trusted advisor, providing conflict free representation with total objectivity