iTRA GLOBAL Corporate Real Estate Scope

6 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 judgements 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.

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 $25 per square foot will add $5,000,000 in debt to its balance sheet (20,000 SF x 10 years x $25/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, $100,000 in construction costs is amortized at $10,000 per year in a ten-year term and $33,333 per year in a three-year term;

B.) Rising rental rates. In Pittsburgh, rental rates have risen each year for the past ten years 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 Pittsburgh 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 as the supply of available office space in premier buildings decreases, as is the case in Pittsburgh.

For more information about this topic please contact Beth Wade, ITRA Global Executive Director, at 706.654.3201 or email bwade@itraglobal.com.

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