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Exclusive

New Accounting Regs Turn Tables On Tenants

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IRVINE, CA—Under the new national standard, both capital leases and operating leases will have underlying assets and liabilities recorded on the balance sheet, Haskell & White's Wayne Pinnell explains **EXCLUSIVELY** to GlobeSt.com.

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IRVINE, CA—A new national [regulation passed recently] by the **Financial Accounting Standards Board**, [ASU 2016-02, Leases (Topic 842)], requires companies with **leases** spanning more than 12 months to report the entire length of the agreement on their balance sheets. Previously, businesses would simply disclose what they paid in rent for the previous year in order to be compliant, transparent and give potential investors a fair idea of the company's value; now, lessees will have to show much more and risk an enormous devaluation.

GlobeSt.com spoke exclusively with Irvine, CA-based accounting, auditing and consulting firm **Haskell & White LLP**'s managing partner **Wayne Pinnell** about the new regulations, how they will affect different parts of the **commercial real estate** industry and what tenants and landlords can do to prevent a complete disruption of the industry.

GlobeSt.com: Please explain the new lease-accounting regulations.

Pinnell: In general, tenants will record all leases on their balance sheets going forward. In the past, **capital** leases were recorded on the balance sheet with depreciation and interest charges only for the related debt being charged to the income statement, and rent for operating leases was recorded directly to the income statement as rent expense, generally on a straight-line basis. Under the new standard, both capital leases (now called "**financing** leases") and operating leases will have the underlying assets and liabilities recorded on the balance sheet. This includes future rents that will have to be paid to landlords in multi-year leases.

GlobeSt.com: How will these regulations affect tenants, landlords and the dynamic of commercial real estate?

Pinnell: With this new obligation to report more leasing information, commercial real estate renters might see an opportunity to purchase their buildings instead of leasing them, since the asset and liability are going to be recorded either way. **Economics**—as well as the geographic area and product types and space desired—will continue to drive the market, but tenants and landlords now have many accounting assumptions that must be made to record their leases at inception and additional assumptions when leases are modified or renewed.

GlobeSt.com: What can tenants and landlords do to prevent a complete disruption of the industry?

Pinnell: The best recommendation is communication and consultation. Tenants and landlords should consult their accounting and tax advisors to get a detailed understanding of these new accounting principles. Generally, I do not recommend that anyone enter into a business transaction because of an accounting implication; but tenants and landlords should understand the ramifications and how it will affect financial and income tax reporting.

In other areas, there is likely to be some confusion because the financial statements of entities post-implementation of this new standard will look quite different. Assets and liabilities will be reflected that were not there before and certain items are likely to be reflected differently in the income statement. As a result, many familiar ratios—such as current or quick ratio, **debt-to-equity**, and asset turnover—will yield different results, and the familiar **EBITDA** calculation may yield different results as well. These changes will affect how real estate brokers and investors (and the industry at large) interpret **financial** data and will affect how financial covenants that appear in agreements such as leases and financing arrangements are negotiated and measured.

GlobeSt.com: What else should our readers know about these regulations?

Pinnell: There is likely a lot of work for companies to do to prepare for implementation of the new standard. While most people recognize the general form of a lease for real estate or equipment, the standard also applies to situations where there may be lease components embedded in another contract. In those cases, the lease component needs to be identified and accounted for separately from the balance of the contract. Also, if a company has a lot of leases (and contracts with leases), it is imperative that an initial inventory of these contracts be made to ensure all original agreements and amendments are “in hand” to allow for a proper assessment of the underlying terms that will affect the required assumptions used for accounting.

Real estate companies will be particularly impacted, but it is also a big issue for any CFO whose real estate strategy plays a key role the company’s balance sheet. For instance, in Orange County, we have a lot of technology companies that lease their facilities, and now they have to reassess their real estate liabilities/opportunities as it pertains to the overall growth and valuation plan. To address this concern, Haskell & White is hosting a complimentary panel discussion from 7:30-9 a.m. on June 15, organized by the **Orange County Tech Alliance**, to explore what **technology** companies should be doing now to address the new standards. Anyone interested can **register to reserve their place**.

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Carrie Rossenfeld is a reporter for the West Coast region of GlobeSt.com and Real Estate Forum. She was a trade-magazine and newsletter editor in New York City before moving to Southern California to become a freelance writer and editor for magazines, books and websites. Rossenfeld has written extensively on topics including commercial real estate, running a medical practice, intellectual-property licensing and giftware. She has edited books about profiting from real estate and has ghostwritten a book about starting a home-based business.

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