New (FASB) Accounting Rules Set to Disrupt Commercial Leasing

New lease accounting standards for commercial properties will force major changes in bookkeeping and real estate strategy.

By Brian A. Lee

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The key to commercial real estate is cash flow. Safety, if not success, comes in numbers, as in the number of tenants an owner has filling up real assets and cutting monthly rent checks. That's why any changes to the rules of commercial leasing, such as those announced in the first quarter 2016 by the regulator Financial Accounting Standards Board (FASB), get a lot of attention in the real estate world.

Perhaps accounting revolution is the better description if it adds $1.35 trillion in assets and liabilities to company balance sheets, as the National Association of Realtors reported.

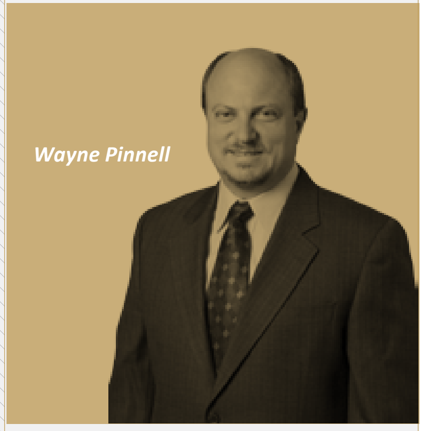
Stephen LaMontagne

"The main challenge will be to understand the tenants' new motivations," says **Stephen LaMontagne**, partner at Moore Colson, an Atlanta-based certified public accounting and consulting firm. "Since the new requirements will result in increased leverage on the tenants' balance sheets, tenants may negotiate for shorter lease terms and/or more variable components to the lease in an effort to minimize the resulting leverage."

According to FASB's "Accounting Standards Update" in late February, lessees will be required to recognize balance sheet assets and liabilities "for the rights and obligations created by those leases." Designed to improve the financial reporting of leases, the new standards terminate what the Securities and Exchange Commission and other parties view as a major area of off-balance sheet accounting. From Enron to the role of CDOs in the Great Recession, many off-balance-sheet scenarios have turned from hidden liability issues to financial horror shows.

The new standard's essential premise is that substantially all leases will be capitalized on the balance sheet, including what was traditionally recorded as capital leases and operating leases. The stipulations bring a whole new focus on lessee assumptions and the key drivers of the lease negotiations, including the initial term and renewal/cancellation options, variable payment streams and residual guarantees, according to **Wayne Pinnell**, managing partner at Haskell & White LLP in Orange County, Calif.

According to **LaMontagne**, the FASB changes have created "pressure points" for the tenant that will increase the risk to the landlord because of the likely increase in financing costs on the property (see raised risk) and decrease in value of the commercial asset due to shorter lease terms and uncertainty with respect to variable payments.



Wayne Pinnell

Plusses & Minuses

When the new rules go into effect in 2019, the lessee balance sheet will be "grossed up" to record "right-to-use assets" and a corresponding lease liability based on the present value of the lease payments.

"Under the adoption criteria for existing leases, the asset will not always equal the liability, resulting in a cumulative change adjustment that is recorded to retained earnings," says **Pinnell**. "By some estimations, there are many leases out there that could result in recording a liability in excess of the asset which would have an immediate negative effect on retained earnings."

LaMontagne points to the change in straight-line rents as a particularly noteworthy item to come out of the comments period leading up to FASB's final pronouncement. The change from lease revenue typically being recognized on a straight-line basis could have a significant impact on how lessors recognize revenue from operating leases related to real estate.

"In the new requirements, to the extent that step rents are used to reflect or compensate the lessor for anticipated market rentals or market conditions, the lessor is required to recognize rental revenues on a systematic basis other than straight-line," **LaMontagne** adds.

Pinnell introduced another consideration: "Companies will find themselves negotiating with other business partners, including banks, when contracts, such as borrowing agreements, have provisions based on liquidity, EBITDA (earnings before interest, tax, depreciation and amortization) and other classic measurements that will generate different results from the new accounting affecting balance sheets and income statements."

Devil in the Details

To implement the new FASB commercial lease standard, companies will need new processes, systems and controls that will impact both their operations and IT departments. Any gaps in staffing, knowledge/training, software and systems, and data storage must be addressed.

"Companies should thoroughly prepare in advance for the changes that the lease pronouncement will have on their balance sheets as the implementation could have significant impact on debt covenants and other financial statement ratios," **LaMontagne** asserts.

After inventorying all leases, organizations will need to determine if they are operating or finance, a classification that will affect the revenue and expense "recognitions" for landlords and tenants, respectively, according to the partner at Moore Colson, a more than 35-year-old accounting firm. In addition, lessees and lessors will also need to identify lease and non-lease components in a contract and allocate the transaction price to the individual components in accordance with the new revenue recognition standard.

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For public companies, the new FASB standard should be adopted for fiscal periods beginning after December 15, 2018, i.e., calendar 2019. The "trick," according to Haskell & White LLP's managing partner, is the requirement for retrospective application, which means large public companies will be restating financial statements from 2017 forward. Private companies have the benefit of one additional year before the advent of new lease accounting standards that will create a new "market standard" for lease lengths and rental rate structures.

"Another issue affecting financial reporting is the adoption of new standards for revenue recognition, the adoption for which is currently one year ahead of the leasing standards," **Pinnell** says. "As such, we are approaching a period of unprecedented changes in major areas of reporting affecting virtually all private and public companies. These landmark overhauls will be challenging companies as they deal with infrastructure, knowledge and personnel issues."