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All Accounted For

FASB Changes Could Create Accounting Headache, CRE Boost

By Driving More Tenants Into Market, Proposed Rules May Create Sales Demand

By Jim Cronin
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Proposed changes to national accounting standards could increase balance sheet liabilities – but if those same changes push commercial tenants to become owners rather than renters, as many commercial real estate professionals believe, they could also help the real estate market.

The Financial Accounting Standards Board (FASB) is considering revising its rules to require that all leases appear as capital leases on company balance sheets, which would increase a tenant firm's reported liabilities.



If the new regulations are put in place, tenants would no longer be able to deduct 100 percent of their rent from the books. That could steer many toward owning property, and would apply to equipment leases as well.

“It affects tenants more than property owners,” said Joe Sciolla, managing partner at CresaPartners real estate advisors. “Would it make more sense to own a building as opposed to leasing it? From an accounting standpoint, probably. It would help the real estate market from the standpoint that it would put more buyers into the marketplace to buy real estate, which always helps sellers to increase the value of their real estate because you have more buyers.”

Start Preparing Now

To wit, the amount owner-occupiers have spent to purchase office buildings increased to \$248.5 million in Massachusetts in 2010, up from \$90.7 million in 2009 and \$34.7 million in 2008, according to statistics from Lincoln Property Co.'s research group. That increase occurred despite a drop in overall commercial real estate sales from \$1.9 billion in 2008 to \$1.3 billion in 2010. Those statistics do not include educational institutions because many colleges and universities have in-house real estate departments.

However, Sciolla said he thinks it is too early to gauge the possible outcomes of the changes if they are passed.

“Our experience has been that the majority of publicly traded companies are either unaware of it or have not focused on it yet because it’s just so far out and it’s just not on their radar screen,” he said.

But firms will need to start preparing sooner than that if they want to comply with the proposed regulations. One requirement would be that companies will need to provide two years of financial statements for comparative purposes prior to the year they go into effect, according to Jonathan Keefe, founder of Manchester-based Real Value Creation, a commercial real estate consulting company.

Firms will need to provide investors and analysts the number to see what the firm’s financials would have looked like under the accounting changes to gauge the company’s performance under the regulations. So, companies will need to start tracking the information required in 2012, said Keefe, who is also director of Boston University’s program for real estate studies.

And many major firms in commercial real estate are taking a hard look at what the proposed changes, which likely will not take effect until sometime between 2013 and 2014, will mean for their companies

The new requirements would compel tenant companies to report outstanding leases in their statements of financial positions just like they would for other outstanding obligations like lines of credit or loans. In other words, if a company is required to pay \$100,000 per year in rent over a five-year term, that yearly expenditure must now be included on balance sheets as a liability – in which case, it may become more advantageous to own than to rent.

Currently, leases are mostly classified as operating leases which have no impact on a company’s balance sheet, and rent is treated as an operating expense that companies are able to entirely deduct from their books.

Looking Ahead

According to a special report from CB Richard Ellis, these changes could impact the future real estate strategies of every stakeholder in the industry, and it has been estimated the proposed change could cause \$900 billion to be transferred to the balance sheets of U.S. companies.

The new standards would require all leases, including those already existing, to be treated as capital leases for accounting purposes. The new standards also have provisions that require company executives – as tenants – to determine whether they expect to renew a lease, which is also recorded on their balance sheet, according to Mary Lentz, executive vice president at McCall & Almy.

“When you start thinking about it, if you have a big portfolio as a tenant ... just the administrative side of that is just overwhelming,” Lentz opined. “You’re going to have to look at a lease and say, ‘Am I going to extend or not?’ and have a legitimate basis for that decision,” as well as having insight into the future of the real estate market.

According to a white paper from CB Richard Ellis, the longer the lease term is, the greater the amount to be recorded on a company's balance sheet. The proposed standard requires renewal options, whether at a pre-determined rate or at a market rate, be considered when determining the term of the lease for accounting purposes. FASB has defined the lease term in a draft as the "longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease."

As a result, the primary lease term, as stated in a lease agreement, will likely differ from the term required to be used for accounting purposes under the proposed new standard, according to the white paper.

For landlords there will be two approaches to lease accounting, according to Keefe. The first is called the performance obligation approach. From a landlord perspective, the right to receive rent is the asset and the obligation to provide space is the liability. The calculations are essentially the same as the tenants. The second landlord approach is called de-recognition, used when the lease is more or less a sale of the asset where the landlord has little or no risk or benefits left in the asset.