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## Federal lease accounting overhaul to impact rental rates and lease terms

By Misty A. Moore

A new change to the lease accounting rules on the horizon could significantly impact the way rental rates and lease terms will be structured in the future.

The U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are on course to jointly issue proposed new lease accounting rules in the third quarter of 2010. The changes, which will take effect by 2013, will affect both public and private businesses. The change, according to the FASB, is meant to stop "significant off-balance-sheet activity for leases."

This could have several significant implications for the leasing market, including causing more companies to buy their offices, driving down the demand for leased space, shrinking the length of a lease term and changing the way lease renewals are structured.

The rule will require companies to book all existing and future leases as assets and liabilities on their balance sheets, which currently are listed as footnotes on most financial statements. As a result of the rule change, companies will suddenly have to record much higher rent, increasing the liability significantly on their balance sheet. For public companies this will result in some \$1.3 trillion in leases on their balance sheets, according to estimates by the Securities and Exchange Commission. For private companies the number will likely be closer to \$2 trillion.

Companies will also now have to report the length of their lease on the balance sheet. As a result companies may opt to shorten their lease terms because it would lessen the amount of debt on the balance sheet. For example, a 10-year lease will mean putting twice as much debt on the balance sheet as a five-year lease.

Under the new rules, renewal terms must also include the lease term plus the renew option. Essentially, if a company signs a 10-year lease with an option to renew for another five years, they must account for the lease as if it were actually 15 years. Again, this will mean adding more debt to the balance sheets, which may result in renewal options becoming less popular.

The change could have several implications for companies, including weakening companies in the eyes of investors and activating debt covenants with lenders. It could also affect credit ratings. While credit ratings agencies already take into consideration rent obligations, the new standard requires additional disclosures that could shed new light on lease terms, which could likely impact companies' credit ratings.

Companies which will likely be most heavily affected by the changes will be companies that are already struggling under heavy debt loads, as well as large retailers that have hundreds of leases. Commercial banks with multiple branches may feel a significant impact.

Jones Lang LaSalle, a global financial and professional services firm specializing in corporate real estate, recently conducted a survey on the proposed rule change and found that while most occupiers expressed some knowledge of the proposed changes to their lease accounting, not a single occupier has fully considered the impact and more than half (56 percent) of the respondents were uncertain of the impact that these changes would have on their balance sheets. The survey also found that landlords believed that most tenants (77 percent) were largely unaware of the topic, but they indicated tenants are starting to raise concerns now.

A majority of the occupiers (88 percent) responded that they would likely seek different lease terms. If those different terms included shorter leases, landlords (64 percent) said that they are willing to consider it and anticipate occupiers seeking such shorter terms after the lease accounting changes take effect.

Respondents to the survey also noted that neither occupiers (72 percent) nor landlords (64 percent) believed that a shift toward ownership versus leasing of commercial space would occur. However, if one-third favor ownership, it could make an impact on the market.

Finally, the survey stated that although occupiers are still mostly unaware what impact lease accounting changes will have on financial reporting, they expect administrative requirements will have significant workload impacts on internal finance teams.

It is important for tenants to take steps now to prepare for the new rules by: understanding and quantifying the impact; preparing finance teams for new reporting; testing how negotiated lease terms drive balance sheet and earning results; and reassessing own vs. lease strategies.

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