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## Accounting rules could alter conventional real estate wisdom

By: **Tim Kilkelly, CNL Commercial Real Estate**

During difficult market downturns such as this, when building vacancies are fostering market rates quite attractive to tenants, proposed accounting changes may prompt companies to think twice before locking into long-term leases.

For the last several years, the Financial Accounting Standards Board, which dictates U.S. standard accounting practices, and the International Accounting Standards Board, which sets the accounting standards for more than 100 countries worldwide, have been working together in an effort to develop more consistent standards. As part of these efforts, the two groups have jointly proposed changes to lease accounting rules.

In essence, the proposed accounting rules would treat future lease payments as a liability rather than an expense, as incurred under current guidelines. In addition, options for renewal of leases would also have to be accounted for as a liability. Consequently, companies with long-term leases would have their liabilities increase, which in turn may make it more difficult to get credit from lenders.

The accounting regulators suggest that these new standards would make investors more aware of the financial liabilities related to a company's real estate. The groups are accepting comments on the recent proposal through Dec. 15, expecting to make a final decision next year. If approved, the new rules would take effect in 2013.

Currently most real estate leases are not treated as financial liabilities, which creates advantages for companies that lease rather than buy properties. On paper, it keeps liabilities and financial risks lower, and lenders obviously view companies with fewer liabilities on their balance sheet as less risky. But, with the new proposed rules, some in the industry estimate as much as \$1.3 trillion in real estate costs would be moved to the balance sheet.

So the question becomes, how will this impact tenants? For many, it may now be in their best interest to sign short-term leases - even for as little as two or three years - and take the risk of higher lease rates in the future rather than risking reduced access to capital with a long-term lease on their books.

Furthermore, these accounting changes could drive a number of businesses out of the leasing market and turn them into property owners, since one of leasing's biggest advantages is not having to record a financial liability on your balance sheet. With these changes, that benefit will disappear.

Though relocating a business will always be a costly venture, this could mean landlords will face even more competition to keep their tenants, significantly changing the dynamics of lease negotiations. Since lenders want to know that the building they are financing will have a continued revenue stream, property owners may continue to offer lower rates or other incentives to help keep their building occupied, even when market conditions rebound.

While accounting changes for leases are still a couple years off, there is one thing I am recommending that my clients do now to make sure they are prepared: Review current leases, since all leases will be impacted; there is no grandfather clause. If companies have leases that are expiring in the next few years, now is the time to start renegotiating - and to do so with these new financial implications in mind.

For those tenants that are already locked into long-term leases, there may be little they can do now other than prepare their businesses as best as they can for the financial impact.

*Tim Kilkelly is a principal in the Tampa office of CNL Commercial Real Estate. He has more than 11 years of real estate experience, specializing in helping companies with large office portfolios meet their real estate needs.*



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