

# Confused by the New Lease Accounting Standard? Here's What You Need to Know.

BY BERT ROSENBLATT AND ANDREW STEIN

Information Source: Robert Cook, [bobcook1234.wordpress.com](http://bobcook1234.wordpress.com)

**On August 17<sup>th</sup>, 2010, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued the "Exposure Draft on Leases."**

It's 66 pages long, and while we commend you if you're one of the few who read the entire thing, we're here to help break it down for you. We've taken much of our info from our friend Bob Cook, whose blog has a variety of posts on the new Lease Accounting Standards. Visit Bob's blog <http://bobcook1234.wordpress.com/> to read all about Lease Accounting. Now let's get down to business. Here's what you need to know.

Changes are coming. It's a done deal. When it will start is not clear, but probably within two to four years. The most important thing to understand is that these changes will make companies less valuable on paper. This is significant if you are a publicly traded company, if you are valuing your privately held company for sale, applying for credit or luring talent via the worth of your company.

If you are a privately held company and you are not looking to sell your company, get a loan or lure talent, then these changes will cost you in terms of compliance (accounting bills will go up), but other than that, they will not have a major impact one way or another.

Here's the big change: right now, companies do not have to put rent on the balance sheet as a liability. When these rules were created about a hundred years ago, most companies owned their property (think Rail Roads, etc.) and leasing of office space was not a significant

line item for most folks, so it was not addressed.

## **Leases on Balance Sheets – What does it mean?**

Under the new rules, companies will add leases as both a "Right of Use" asset and a "Lease Liability" on the balance sheet. Here's how it works: you start with a net present value ("NPV") of the entire lease obligation. (The basic idea of NPV is that it is more valuable to get money up front than over time – you can have a million dollars a year for ten years or eight million dollars right now).

So let's say you have a ten year lease at a million dollars a year, the NPV (depending on the interest rate you apply) will be about \$8 Million. That is your Right of Use asset value. And on the liability side you have the same \$8 Million dollar as a Lease Liability.

Looks like they zero each other out...so who cares, right? Wrong!

The problem is on the income statement. Instead of rent of one million, you have an amortization of that asset on one side of the ledger and "imputed interest" on the liability, on the other. Technically speaking, the actual rent you pay is divided into the imputed interest portion and a pay down of the liability portion.

In English, this means that in the same way you pay mostly interest at the start of a mortgage, these new standards treat rent liability similarly to how interest and principal are treated in an amortizing loan. In other words, the income statement will be skewed against you in the early years of a lease and in your favor in the later years – your \$8M asset is offset by a liability of more than \$8M in the early years and less than \$8M in the latter years of the lease.

### **Practically Speaking Here Are The Main Issues:**

*Under the new rules, short leases are better for your balance sheet.*

Because of the way Lease Liability is treated, companies looking at real estate decisions are now faced with the accounting reality that the longer the lease, the longer it takes to get over the hump to the point where the asset side equals or overshadows the liability side of the equation. So from a pure accounting perspective, shorter leases are better for the balance sheet.

*No Grandfathering.*

Let's say on the effective date of these new regulations you have 8 years left on a 20 year lease obligation, what happens? You will be treated as if you just signed a new 8 year lease and you are in the same boat with respect to the balance sheet and income statement as someone who just signed a new lease.

*What about Renewal Options?*

So you're thinking okay, I'll beat the system by signing a series of short term leases with short term options. Sorry. Under these new rules as they are presently being proposed, auditors are going to look at your assumptions carefully. They're going to ask the question, how likely is it that you exercise these options? If the answer is it's likely, they're going to treat all your renewal options as part of the original term. In other words, if you have a 5 year term with two 5 year options, it will be treated on day one as a 15 year lease. And make no mistake;

auditor scrutiny will be high, particularly at the beginning.

*Own vs. Lease – what makes sense?*

Most companies chose to lease vs. own their office space for two reasons. One, they want to put their working capital into the business, not the real estate. Two, they do not want assets on their balance sheet that do not have an appropriate off-setting ROI to balance them out.

Under these new accounting rules, leased space on the balance sheet will be treated in the same way as if you owned the property – so one of the two big reasons to lease vs. own is gone. Still, the question of what to do with working capital will keep lots of people renting their space.

**Bottom line – what do we do?**

Under these new rules, your balance sheet looks better if you do short leases, but should you? It's a business decision. Those making real estate decisions for their firms with respect to lease term will need to weigh how important it is to them to have better earnings on paper in the immediate future (or early years of a lease), vs. locking in a long term lease deal with fixed costs that perhaps take advantage of favorable market conditions. Answering this question comes back to the issue of how likely (and valuable to you) is it that you'll need to use your financial statements to communicate your financial position – to banks, shareholders, new potential partners, on the one hand, and what is happening in the real estate market on the other.

These are issues to be talked through carefully with your accountant, attorney and real estate broker. Also, be aware that these new regulations will come with all sorts of compliance head-aches. Start planning for them now.

*Bert Rosenblatt and Andrew Stein are principals of Vicus Partners, LLC and the ITRA affiliate for New York City – Downtown. Bert Rosenblatt can be reached at (212) 880-3747 ext. 6619 or at [broosenblatt@vicuspartners.com](mailto:broosenblatt@vicuspartners.com). Andrew Stein can be reached at (212) 880-3747 ext. 6620, or at [astein@vicuspartners.com](mailto:astein@vicuspartners.com)*