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Tenant's Place

Market News and Commercial Real Estate Strategy for the Twin Cities Office Tenant

New Lease Accounting Standards on the Horizon

On August 17, 2010, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly released an exposure to update both US and international accounting standards related to accounting for leases. To call this an update is an understatement as it is a dramatic change from how most leases have been accounting for in the past. The proposed standard follows what is called a "right-of-use" model in accounting for all leases with only minor exceptions.

The draft accounting standard proposes the following:

- (1) A lessee ("tenant") would recognize an asset representing its right to use the leased (underlying) asset for the lease term (the "right-of-use" asset) and a liability to make lease payments
- (2) A lessor ("landlord") would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would either:
 - a. Recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach); or
 - b. Derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognizing approach)

The concept of a capital lease vs. an operating lease disappears with this standard with essentially all leases treated similar to what currently are considered capital leases. The new standard is both complex and comprehensive with changes that take into consideration options and contingent rentals. In addition, the pattern of income and expense recognition in the income statement will differ significantly over the life of a lease.

A quick demonstration of the impact of this proposal on a lessee is an office space lease at \$12,000 per year over 10 years. Currently standards would require the expensing of the lease payments on a straight-line basis over the life of the lease, or \$12,000 per year with no balance sheet impact. Under the new standard the lessee would record a liability for the present value of future lease payments using the lessee's incremental borrowing rate (assuming 5% this would result in a liability of approximately \$94,300) and a corresponding right-of-use asset for the same amount plus any costs associated with acquiring the lease. The right-of-use asset is amortized on a straight-line basis over the expected life of the asset and the liability is reduced as payments are made with interest expense recognized similar to debt.

Although the fundamental economics of the lease have not been significantly affected, the impact on financial statements can be dramatic. As noted above, current standards result in annual expenses of \$12,000 each year of the lease. Under the new standard expenses would be approximately \$14,000, \$9,430 from amortization of the "right-of-use" asset and \$4,570 in interest costs. Also, the lessee's debt to equity ratio would change with the lease obligation not included as part of their debt. Both working capital and current ratios would also decrease. The impact on a lessor's financial statements are just as dramatic as for the most part they will mirror the treatment of their lessee.

Now add contingent rental payments, disparate treatment of service components, lease renewal option considerations and estimates for the probability of outcomes and payment streams for the above, along with a periodic requirement to evaluate these factors, the complexity of the proposed standard becomes evident. There is little doubt that at least initially, we can count on confusion to reign for non-accountant users of financial statements.

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Although these are proposed standards, it is anticipated final standards will be issued by early 2011, with an impact on all leases and contracts in place at the time the standard is first implemented. The effective date of this proposed standard will be discussed in a separate project on effective dates of various proposed standards.

Article by Harold Parsons, CPA, Engagement Principal of LarsonAllen LLP. LarsonAllen LLP is a professional service firm that provides assurance, accounting, tax, consulting and advisory services. Harold has over 28 years of experience serving primarily not-for-profit organizations. Source: larsonallen.com

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jaclyn.may@northmarq.com
if interested in a free seminar.

HOW HAVE WE HELPED A TENANT RECENTLY?

I need more space NOW, but I have 2 years left on my lease! *

A client of ours was outgrowing their space. Initially they considered expanding. After meeting with our team, we determined their current space was underutilized. With our involvement, we reconfigured the current space AND the landlord paid for 50% of the costs to accommodate their growth in exchange for extending their lease term by 18 months.

*** - If you find yourself in a similar situation, please contact us. We will meet with you at NO COST to learn more about your situation and determine how we can create a solution.**

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AGE-OLD ADVICE...

1. Start your planning process NOW if you have 24 months or less remaining on your lease.
2. Be familiar with your lease options. Exercising an early renewal or early exit option could benefit you greatly.
3. Plan ahead and budget accordingly. Leases often have rent increases that occur later in the term.
4. Stay smart and get good advice. We're ready to listen.

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