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## New Accounting Standards That Will Affect Your Nonprofit

By Jennifer Haddon, CPA

Hang onto your hats ... a major change in the accounting rules is coming which will affect all organizations that have entered into leases. All leases are included – be they for space, for copiers, for vehicles, and everything in between.

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have been working on several joint projects as they move to the creation of a single set of international accounting standards which converge generally accepted accounting principles accepted in the US (US GAAP) with other international standards. One of these projects which they hope to complete in 2011 is on Lease Accounting.

Under the current accounting for leases, leases are classified as either capital leases or operating leases. Through a series of questions, an organization determines whether a lease is capital in nature or operating; the questions relate to ownership at the end of the lease term, length of the lease term as compared to the economic life, and the value of the payments. If a lease is determined to be capital in nature, it is recorded as an asset and liability on the Statement of Financial Position (balance sheet). If it is determined to be an operating lease, there is no impact to the balance sheet; the terms of the lease are disclosed in the footnotes. Generally, for the non-profit organizations we work with, copier leases are often found to be capital, while occupancy leases are not.

The FASB and the IASB has several concerns with this two-method approach. This methodology leads to many long-term contracts not being shown on the balance sheets of lessees, despite an organization's obligation to fulfill the commitment. Also, similar transactions could be accounted for differently by different organizations, which reduces comparability between entities. Other concerns include: increased opportunity to structure leases to achieve a particular outcome; users of the financial statements have difficulty estimating the effect of operating leases on their ability to leverage; and variable features (such as renewal options or contingent rentals) are usually accounted for as they occur, making it more difficult to assess the effects of those features on future cash flows.

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The new proposed accounting standard establishes one method of accounting for leases by lessees. All types of leases would be recognized on the balance sheet as an asset (representing the right-to-use the leased asset) and a liability (representing the obligation to pay the rent, calculated at the present value of the expected lease payments). By using a single method, FASB/IASB anticipates this will produce more complete and comparable financial statements, reduce the opportunity to structure transactions a particular way to achieve a certain accounting outcome, and provide users of the financials with a more accurate view of a company's liabilities and future cash flows.

Here is a simple example to illustrate the accounting. Imagine an organization has signed a 10 year lease at a fixed \$10,000 per month, for a total of \$1.2 million over 10 years. Under the existing accounting rules, if this were considered an operating lease and the organization would recognize \$120,000 of lease expense annually; the lease would not be recorded on the balance sheet.

Under the proposed new accounting rules, this lease would be recorded as an asset and liability. One way to calculate the value of this lease would be to look at the incremental borrowing rate (that is, if you were to borrow the funds instead of paying rent, what rate could you obtain?) For illustrative purposes, let's say, 5%. Based on this, the net present value is only \$943,000, which is what would be recorded as the asset and liability. Each month, rather than recognizing \$10,000 in lease expense, the organization would recognize depreciation and interest expense. While cash flows would remain the same (\$120,000 a year), the expense recorded would be higher in the earlier lease years and less later on.

If adopted by FASB, the proposed new lease accounting will have a major impact on all organizations, including non-profits, as all leases will need to be recorded on the balance sheet. There will be no "grandfathering" in of existing leases, though there may be a simplified approach for short-term (less than 1 year) leases. Once the new standard is effective, any leases in place will need to be evaluated for the remaining lease term.

FASB/IASB recently extended their projected completion date to later in 2011. The implementation date has not yet been determined, but generally organizations have at least a year to implement new standards. More detailed information is available on FASB's website, [www.fasb.org](http://www.fasb.org).

To prepare for this upcoming change, we encourage organizations to make sure that they have all of their lease documents in order. It may also be helpful to schedule out the lease terms and payment due, as this will make it easier to fully analyze and implement the new standards.

#### ***About the Author***

*Audit Manager Jennifer Haddon joined the firm in 2001. In addition to over seven years of banking and accounting experience in the field, she has also worked for a not-for-profit legal aid organization. She is a member of the American Institute of Certified Public Accountants (AICPA) and Washington Society of CPA's (WSCPAs), serves as a tutor with the Youth Tutoring Program and is an accounting mentor at the Seattle University, Albers Business School.*