

# The Advisor

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## Lease Accounting - Are You Following the Rules?

In 2005 proper accounting treatment for operating leases was a hot topic, particularly related to building leases. Through the end of April 2005, approximately 250 publicly held companies restated their past financial reports, revised their accounting policies or warned that they were reviewing their accounting lease policies, all because of lease accounting issues.

### What Accounting Treatment Would You Like?

The easiest way to account for a lease is to treat it as an operating lease. The accounting is simple; it is expensed as you pay. There is no capitalization and depreciation of the property, a liability is not recorded, and the monthly payment is simply charged to rent expense.

### Did the Rules Change?

No, the rules did not change. The same guidance has been in place since 1973!

### What Do You Need To Watch For?

Basically, several areas have caused issues: The life of amortizing lease improvements, rent holidays and landlord paid improvements.

- **Amortization/Depreciation Period for Leasehold Improvements:**

The rules state that leasehold improvements should be capitalized and amortized or depreciated over the shorter of (1) the useful life of the improvements or (2) remaining lease term. Careful consideration must be given for renewal options. Depreciation expense could be misstated if this rule is not followed, thus misstating operating income.



*If you have any questions  
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- **Rent Holidays:**

Sometimes a landlord may give a “rent holiday” before you are required to begin paying rent. The accounting rules require that the total lease expense for the life of the lease be spread over the lease term. Therefore, rent expense is recorded, even in the rent free period. Basically, the rent is smoothed over the entire term of the lease.

This gets a little complicated when you have to explain why you have a liability for rent on your balance sheet in the beginning of the lease term (since you recorded the monthly expense, but did not pay out anything yet).

- **Landlord Paid Improvements:**

Sometimes landlords will give you money for improvements or pay for them. Under the accounting rules, the tenant must capitalize the improvements and amortize or depreciate them over the shorter of (1) the useful life of the improvements or (2) remaining lease term.

In these cases, when the improvements are capitalized, a corresponding liability should be recorded and amortized straight line over the lease term as a reduction of rent expense.

The net impact is that you increased your depreciation expense and you reduced your rent expense. In most cases, these will net to zero or a slight difference. There are possible exceptions when renewal periods in a lease exist. In addition, it can impact your current ratio as a portion of the liability eventually will be recorded as current. The capitalized improvements are recorded as non current assets.

## Confused?

As you can see by the number of restatements of financial statements, so were many others. There are many factors to consider to determine the proper accounting treatment for leases.

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