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The FAS 13 / IAS 17 Lease Accounting Group

In Cooperation with the CoreNet Global Strategy &
Portfolio Planning Community

Present

Corporate Real Estate Implications of Planned Lease Accounting: A Working Session

STRATEGY & PORTFOLIO
PLANNING COMMUNITY



Agenda

- **Purpose and Structure of Working Session**
 - Introduction of Moderators and Key Speakers
 - List of participating Subject Matter Experts (“SME’s”) and Listeners
- **Current Understanding of Proposed Lease Accounting**
 - Presenter #1: Mindy Berman, Jones Lang LaSalle
 - Presenter #2: Jeanne St. John, CresaPartners
 - Commentator: Dale Schlather, Cushman & Wakefield
 - Additional Commentary: Moderators and SME’s
- **Q&A with SME’s (voice-enabled) and Listeners (WebEx chat)**
- **Influencing the Outcome**

Disclaimer

- **The views expressed in this presentation by anyone associated with FASB, IASB, or accounting / consulting firms are their own, and do not represent positions of said organizations. Positions of the FASB and IASB Boards are arrived at only after extensive due process and deliberations.**
- **John Bober of GE Capital has requested not to be quoted in any external media communication.**
- **No participant in this Working Session shall be considered to be giving accounting or tax advice to any other.**

Moderators and Key Speakers

- **Michael Anderson – CoreNet Global**
 - Manager of Research & Knowledge Center
- **Russell Howell – SVP, Portfolio Strategy, Johnson Controls**
 - Corporate Real Estate Services and Transaction Structures
- **Richard Podos – President, Lance Capital LLC**
 - Lease Structuring / Funding for Tenant Improvements, BTS, and SLB
- **Mindy Berman – Managing Director, Corporate Capital Markets, JLL**
 - Corporate Real Estate Financial Structures
- **Jeanne St. John – Transaction Manager, CresaPartners Capital Markets**
 - Corporate Real Estate Financial Structures
- **Dale Schlather – EVP, C&W; Chairman, CoreNet Global NYC Chapter**
 - Tenant Representation and Corporate Services

Subject Matter Experts (voice-enabled)

Mathew Stone (London)

John Wilson (London)

Todd Anderson

Kyle Gore

Ralph Petta

Dean Hodcroft (London)

Bob Cook

John Bober

Rachel Knublely

Barclay Jones

Louis J. Battagliese

Michael Evans (London)

Erik Lange

William Bosco

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Ex-Sun Microsystems

GE Capital

IASB

iStar Financial

Jackson Cross

Jones Lang LaSalle

KPMG

Leasing 101

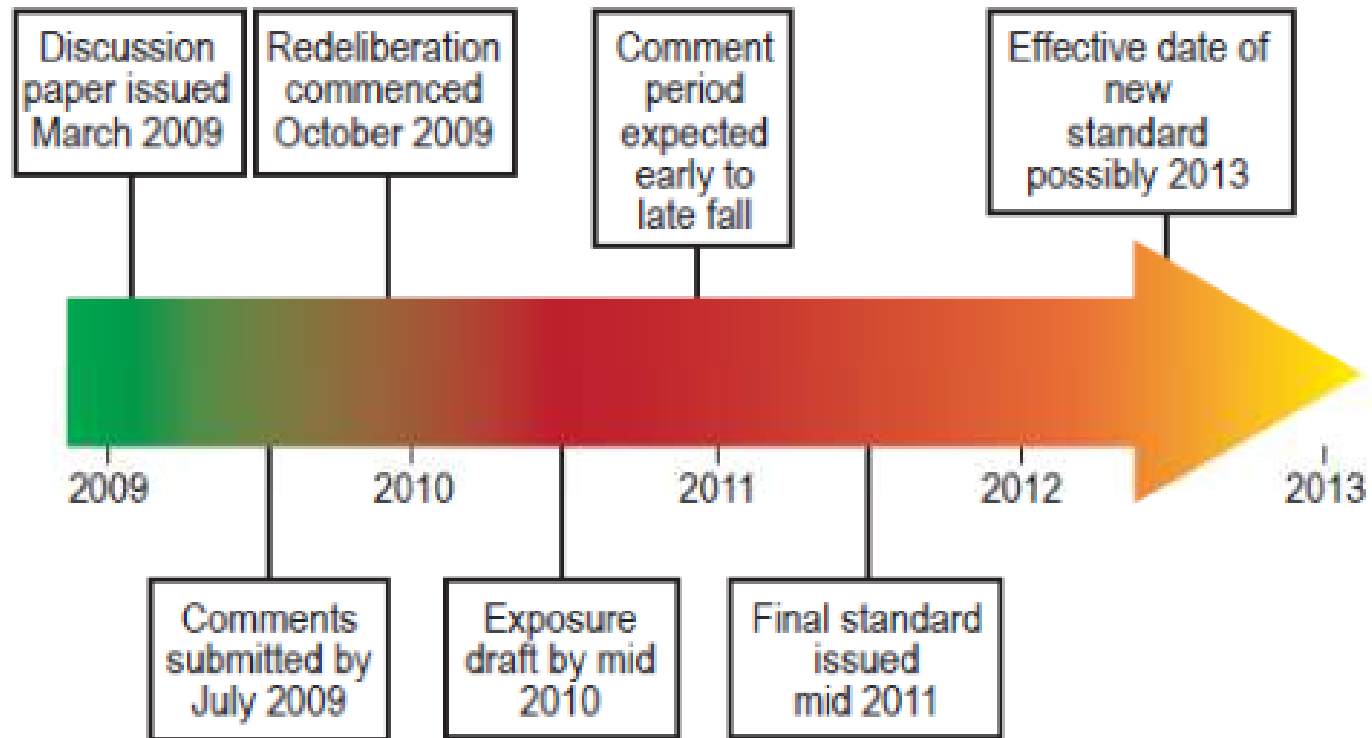
Penn State University

Transwestern

Lease Accounting Project

- **Joint project of FASB and IASB**
- **Real estate leasing will be significantly impacted**
- **70% of operating lease value is real estate; total U.S. balance sheet effect estimated at over \$1.25 trillion**
- **Every company and organization that follows US GAAP or IFRS will be impacted**
 - Public, private, not-for-profit
 - No matter where property is located

Timeline



Current State

- **Leases are classified as operating or capital**
 - ***Operating***
 - Leases are not on a company's balance sheet
 - Rent payments reported as rent expense on a company's income statement
 - ***Capital / Finance***
 - Leases require an asset and debt on the company's balance sheet
 - Asset is depreciated and debt is split between interest and principal

Criticisms of Existing Model

- **Difficulties in determining the dividing line between an operating versus finance lease**
- **Non-recognition of obligations in an operating lease**
- **Different accounting models for similar transactions**
- **Structuring and accounting arbitrage opportunities**

Proposed New Standard

NO MORE OPERATING LEASES

- **All leases will contain:**
 - “Obligation-to-pay” liability
 - Corresponding “right-of-use” asset
- **Scope**
 - Leases as exist under FAS 13 and IAS 17, including leases embedded in service arrangements
 - Existing and future leases, regardless of location
 - Leases that are not a purchase or sale of an asset
 - Simplified accounting guidance for short-term leases (< 12 months)

Comparison with Existing Model

Financial statement impact	Operating lease	Finance lease	Right-of-use model
Balance sheet	<ul style="list-style-type: none"> • Prepaid rent expense 	<ul style="list-style-type: none"> • Leased asset • Finance lease liability 	<ul style="list-style-type: none"> • Right-of-use asset • Obligation to pay rentals
Income statement	<ul style="list-style-type: none"> • Rent expense 	<ul style="list-style-type: none"> • Depreciation • Finance expense 	<ul style="list-style-type: none"> • Amortization • Finance expense



Initial Measurement

- **Lease obligation**
 - Present value of lease payments discounted at lessee's incremental borrowing rate
 - **Most likely lease term (consider renewals and terminations)**
 - **Includes estimate of contingent rent and any residual guaranty**
 - **Does not include operating expenses**
- **Right-of-use asset**
 - Cost (present value of the lease payments plus any initial direct costs incurred by the lessee)
 - Starting amount the same as liability

Subsequent Measurement

- **Asset**
 - Amortized straight-line (subject to impairment)
- **Obligation**
 - Amortized cost using effective interest method
- **Assumptions updated each reporting period (*i.e. lease term, residual value guarantee, contingent rent*)**
 - Allocate changes to asset, obligation and net income

Other Issues

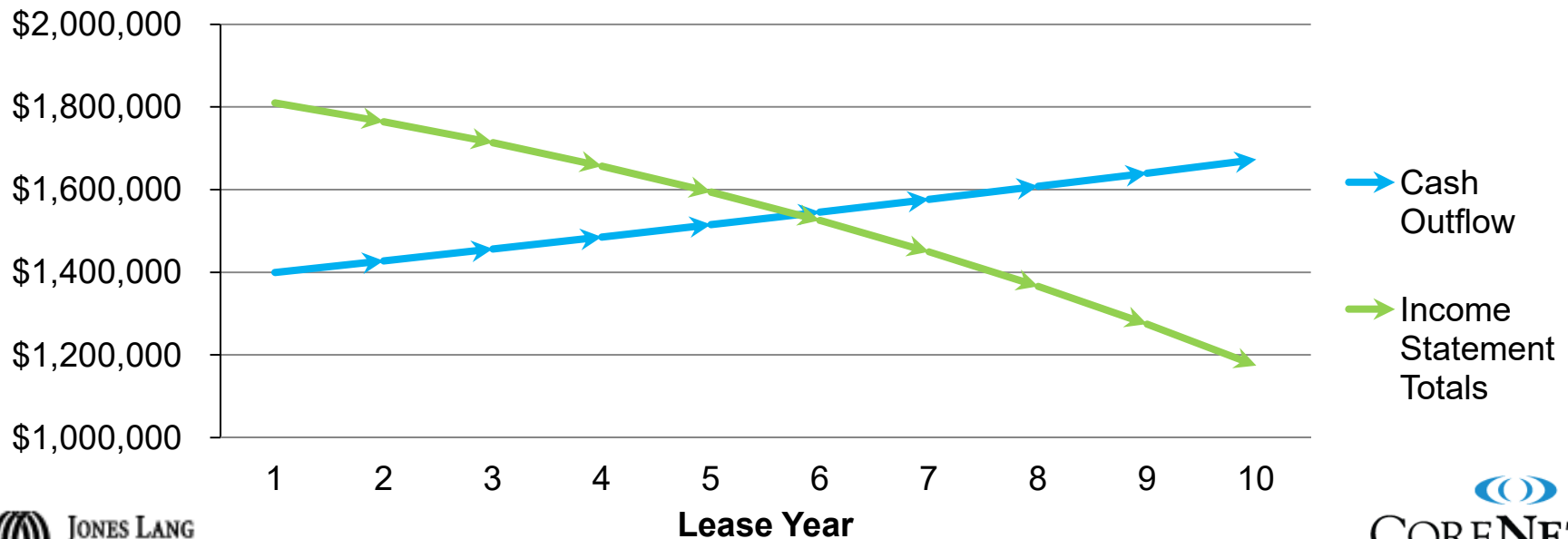
- **Sublease accounting**
- **Sale-leaseback arrangements**
 - Financing or sale
 - Gain recognition
- **Build-to-suit arrangements**
- **Lessor accounting**
 - When to apply:
 - **Performance obligation**
 - **De-recognition**

Lessors Accounting

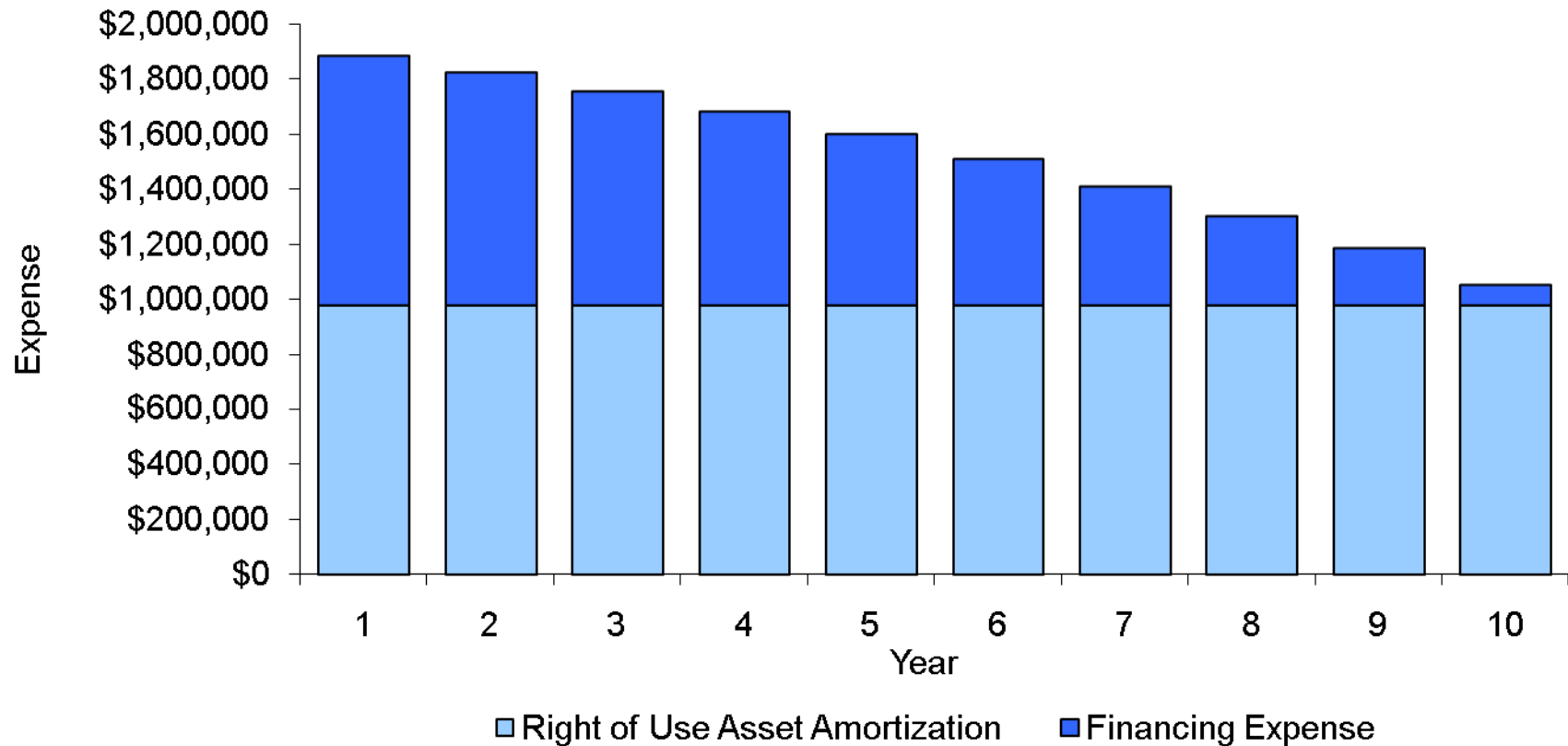
- **Two models currently under consideration**
 - Performance model
 - Derecognition
- **Other points**
 - Not necessarily symmetrical with lessee accounting
 - Subleases to be accounted for through lessor accounting

Income Statement Changes

- **No more rent expense**
- **Occupancy expense will consist of amortization and interest expense**
- **Early in a lease, amortization plus interest expense will be greater than rent**



New Occupancy Expense

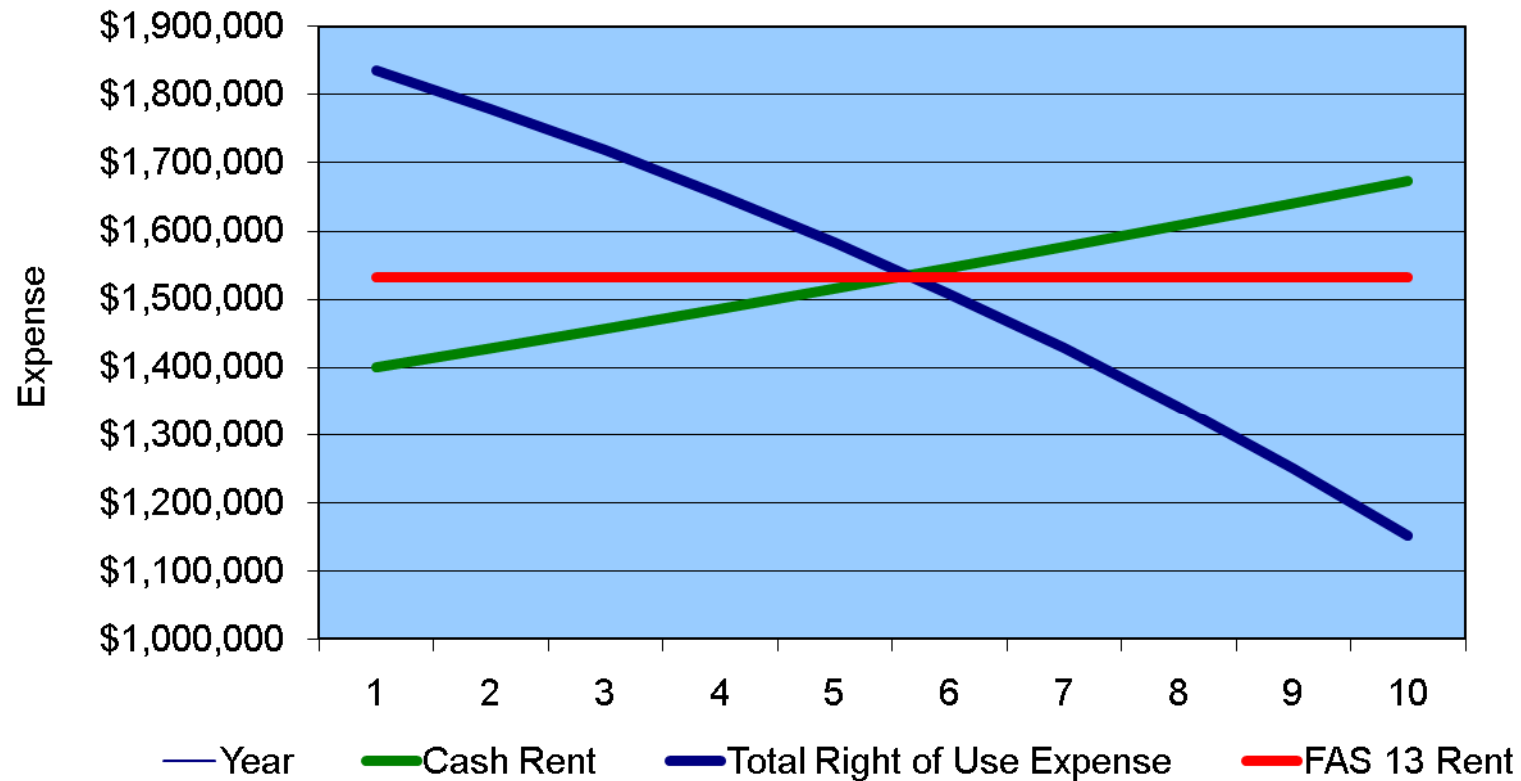


100,000 s.f. lease for 10 years; \$14 NNN rent; 2% annual escalators, 7% corporate borrowing rate

Why Should I Care?

- **No “grandfathering” is expected**
- **All existing leases need to be reviewed and reflected on balance sheet**
- **More volatility could be introduced in the income statement**
- **Future transactions should consider the new guidelines to avoid surprises**
- **Continuous re-evaluation of lease contracts over their life**
- **Those most informed about the company’s real estate and the real estate market need to be involved in the evaluation and implementation processes**

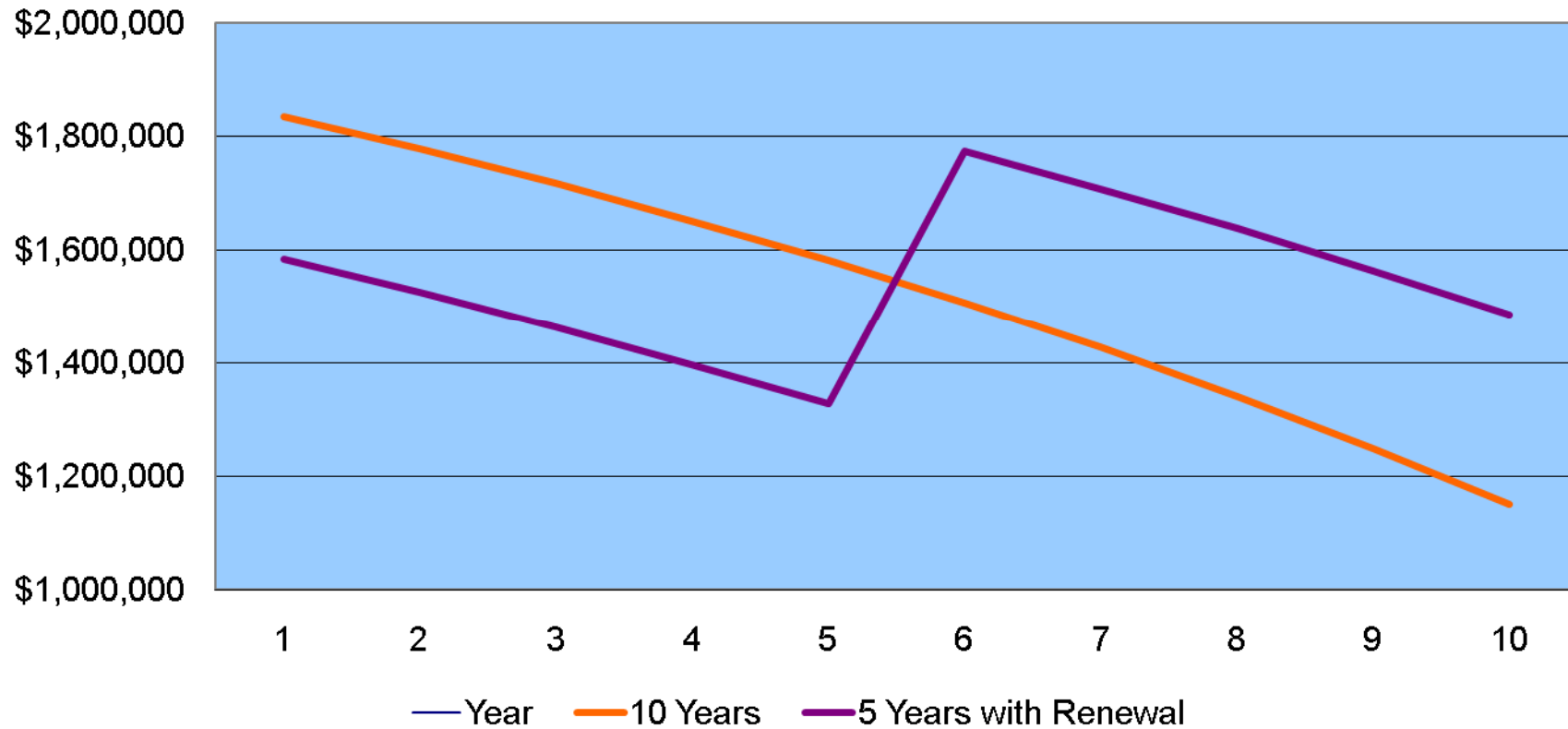
Comparison of Occupancy Expense



100,000 s.f. lease for 10 years; \$14 NNN rent; 2% annual escalators, 7% corporate borrowing rate

Impact of Lease Term

Expense profile of five-year lease with renewal vs. ten-year lease



Impact of Borrowing Rate

PV of rents at 7%	\$10,950,000
PV of rents at 9.5%	\$9,800,000
Difference	\$1,150,000 or 11%

Interest rate environment and corporate credit quality will determine incremental borrowing rate used to measure right-of-use asset and liability

Implications

- **Substantial increase in corporate balance sheets**
- **Loss of straight-line rent expense in exchange for high-low expense profile**
- **Improved EBITDA**
- **Higher reported capital spending**
- **Potential violation of financial covenants**
- **No expected change in credit ratings**
- **Change in expense allocation to business units**
- **Greater regulatory capital for financial services companies**
- **Increase in financial reporting burden**
- **Change in desired lease terms and structure**
- **Change in lease vs. own decision-making**

Considerations for Determining Capitalized Lease Amounts

- **Determination of net rent amounts**
- **Evaluation of most likely least term**
- **Assessment of termination, contraction and expansion rights**
- **Estimates of contingent rents – CPI escalators; percentage sales**
- **Estimates of forward currency exchange rates**
- **Continuous re-consideration of estimates and assumptions of the above**
- **Determination of discount rates**

Economic Transparency?

- **Reported occupancy expense inverted from cash rent**
- **Reasonable judgment about lease term and contingent rent can make reporting of similar leases non-comparable**
- **Recognition of liabilities that are not legal obligations**
- **Continuous adjustments of capitalized amounts**

How are Corporations Preparing?

- **Corporations Acting as a Catalyst**
- **New Challenge – Socializing new accounting standard**
 - Each industry – may view impact differently
 - Impact of exposure draft – time to begin discussions
 - Recognition of expenses - first year
 - Internal customers perception
 - Capital policy
 - Equipment and Fleet leasing

Communications – Internal and External

- **Internal**
 - Open dialogue with Chief Accounting Officer
 - Discuss capital deployment with Treasury
 - Lease vs. owned - time to position desired mix
 - Flexibility
 - Review with Lease Administration Group
 - Is all the data being collected or broken out
 - How robust is the reporting
 - Start testing your data (auditable results will be required)
 - Staffing
 - Portfolio review
 - Examine a few leases for impact
 - Transactions – long term vs. short
 - Projects – investments

Communications – Internal and External

- **External**
 - Begin discussion with vendors and Outsource Partners
 - Lease Administration
 - IWMS provider
 - Brokers
 - Appraisers

What Tools and Resources Do You Need?

- **Practical Considerations**
 - Debt Covenants
 - ERP Systems
 - Lease Admin Standards
 - Capital Approvals
 - Decentralized Control
 - Materiality Question
 - Change Management
 - Non-Real Estate Leases
 - Skills and Staffing

What Tools and Resources Do You Need?

- **Preparation**
 - Raise Organizational Awareness
 - Re-visit Major Planned Leases
 - Segregate NNN costs from OE
 - Readiness Assessments:
 - Systems
 - Docs
 - Financial Impact
 - Build Total Lease Inventory
 - Develop Standards:
 - Approval
 - Rules
 - Change Management
 - Design Processes

Q&A with Subject Matter Experts

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Influencing the Outcome

- *Key Issues for Change*

- **Differences in market practice between equipment and real estate**
- **Financial reporting versus Corporate RE operations**
 - I.E., on-balance sheet is fine, but in a way that makes sense
- **Specific desired changes to plan:**
 - Straight-line rents
 - Amortize like a mortgage, not straight-line of principal
 - Gross versus net rents
 - No projections of contingency rents
 - No projections or inclusion of renewal options
 - Address “gaming the system”
 - No projection of currency exchange rates
 - No impairment of “right-of-use” leased asset
 - Eliminate re-measurement at every reporting period
 - Sarbanes-Oxley issues

Influencing the Outcome

- **Ongoing communication with FASB / IASB members and staff**
 - Information about commercial real estate lease practices, scale and complexion of real estate leasing market, and impact of Lease Accounting proposal
 - Explain how proposals may or may not achieve Boards' stated objectives
- **Engage real estate investor community**
 - Awareness of tenant impact and potential changes to desired lease terms
 - Lessor accounting implications
- **Collaboration with other trade associations and industry groups**
 - Loose confederation of groups active for several years
 - ELFA, NAREIT, ICSC, Real Estate Roundtable, ULI, Chamber of Commerce, etc.... now CoreNet Global as well
- **Mobilize corporations, investors, analysts to comment on Exposure Draft**
 - Number and quality of comment letters matter!

Available Recent Resources at:

www. <http://network.corenetglobal.org/CORENETGLOBAL/corenetglobal/Directory/BlogViewer/Default.aspx?BlogKey=84df84fe-05a5-4feb-8a78-07570a9263a5>

- **Articles and Whitepapers**

- 6/2010, NY Times: “[New Accounting Rules Ruffle the Leasing Market](#)”
- 5/2010, CPA Journal: “[Capitalizing Lease Payments](#)”
- 5/2010, CFO.com: “[Leases Headed for the Balance Sheet](#)”
- 5/2010, PwC: “[The Overhaul of Lease Accounting](#)”
- 3/2010, Transwestern: “[The Effects on Our Industry](#)”
- Winter 2010, C&W: “[Operating Leases – The Finale?](#)”
- Fall 2009, CBRE: “[FAS-talking](#)”

- **Presentations**

- 6/2010, CNG SPP: This webinar presentation
- 6/2010, JLL: “[How Will Changes in Lease Accounting Affect You?](#)”
- 6/2010, CNG Eastern Regional Symposium: “[What’s Happening to the Bottom Line](#)”
- 5/2010, FASB: “[Lease Update](#)”
- 4/2010, CNG Global Summit: “[What Corporate RE Needs to Know](#)”

- **Industry Association Letters**

- 7/2009, ICSC: “[Response to Lessee / Tenant Aspects](#)”
- 7/2009, ELFA: “[Comments on...Revision of Lease Accounting Standard](#)”

Thank You

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