

The overhaul of lease accounting: Catalyst for change in corporate real estate

May 2010



Executive summary

The International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) (collectively, the “Boards”) are nearing the Exposure Draft stage (expected issuance in mid-2010) on an ambitious joint proposal that would radically transform lease accounting from the existing model which has existed for over 30 years. These changes would impact almost every company but are especially relevant to those that are significant users of real estate. The proposal suggests a completely new model for lessee accounting under which lessee’s rights and obligations under all leases, existing and new, would be capitalized on the balance sheet.

In March 2009, the Boards issued a discussion paper: “Leases: Preliminary Views.” The paper described a right-of-use model for lessee accounting. Using the feedback received in more than 300 comment letters, the Boards began deliberating the proposed model in October 2009 with an eye towards issuing a new accounting standard in final form in mid-2011. The new standard would require adoption potentially as early as 2012. While there may be some slippage in these dates, many companies will need to start addressing these issues now in order to be prepared for the change.

At a minimum, compliance with the proposed standard will require companies to thoroughly overhaul their legacy accounting systems, processes and controls. Importantly, the proposed standard will also have a significant impact on a company’s operating results, financial ratios, and potentially their debt covenants.

For most companies, the cost of real estate represents one of their largest cost items. And yet, the existing corporate real estate function may have been designed to support a very different operational structure compared to what exists today or one which was originally motivated by financing or tax considerations that no longer apply.

For some companies, the proposed lease accounting standard will present just another compliance issue entailing significant readiness costs that will need to be managed. Such costs will include education, the need to size the impact of the proposed standard on the financial statements, robust systems upgrades and implementation of new controls. For others, in addition to the compliance

issue, the proposed standard will be a much-needed catalyst for revolutionary change in their overall corporate real estate strategies. Thus, the lease project, coupled with change impetus from other current economic, tax and business issues, may drive some companies to radically overhaul their real estate strategies.

Overview of the proposed new lease standard

- Proposal will eliminate off-balance sheet accounting; essentially all assets currently leased under operating leases will be brought on balance sheet
- Income statement “geography” and timing of recognition will also change because straight-line rent expense will be replaced by interest expense (which will be greater in earlier years, like a mortgage) plus straight-line amortization of the leased asset, such that total expense will be front-ended
- These new assets and liabilities will be recognized and carried at amortized cost, based on the present value of payments to be made over the term of the lease
- The lease term will include optional renewal periods that are more likely than not expected to be exercised (this is substantially different than today’s model). Lease payments used to drive the initial value of the asset and liability will now include “contingent” amounts, such as rents based on a percentage of a retailer’s sales and rent increases linked to, say, CPI
- Lease renewal and contingent rents will need to be continually re-assessed, and the related estimates trued up as facts and circumstances change
- The proposed lease accounting model will require significant systems and process changes at adoption date and maintenance on an ongoing basis
- Pre-existing leases are not expected to be grandfathered

A detailed summary of the key provisions of the lease project as well as a practical example have been provided as an Appendix to this paper.

Some fundamental questions

As you assess your current corporate real estate strategy, there are a number of fundamental questions that come into play, such as:

- Why does your company lease or own in particular situations?
- What are the alternatives to leasing?
- What are current market opportunities (e.g., lease rates/purchase prices) and how would they affect your real estate strategy?
- How do federal, state and local taxes factor into your corporate real estate decisions?
- How does your company manage occupancy costs today?
- What is the potential impact of the proposed lease model on your company?
- What changes will your company need to make to manage the process?
- Do your company's existing systems have the capabilities necessary to apply the proposed lease standard?

The “stake holders”

Corporate real estate activity affects a number of key functional areas and any reconsideration of your approach should include, at a minimum, members of each of the following key constituencies:

- Accounting/reporting
- Treasury
- Legal/regulatory
- Operations
- Tax planning and reporting
- Information/systems
- Human resources
(e.g., impact on compensation agreements)

Each of these stake holders are potentially impacted by the proposed accounting standards. Many of these impacts are readily apparent; for example, the impact of the proposed lease accounting model on financial reporting and debt covenants. Other impacts may be less obvious or may be specific to a particular industry including, for example, impact on compensation tied to company performance or on legal/regulatory capital. Accordingly, it is essential for companies to seek broad participation in the process of identifying and addressing the potential impacts of the proposed lease accounting standard. Best practice is to form a “steering committee” comprising members of each of these constituencies.

Factors that impact corporate real estate strategy

The proposed standard will be the catalyst for companies to take a fresh look at factors that impact corporate real estate strategy.



Many of these factors drive the decision to lease a particular asset versus buying it. For many entities, the original reasons for these decisions and policies are no longer relevant. For example, transactions previously structured for off-balance sheet benefit at a higher cost compared to straight borrowing may no longer be optimal.

Operational issues

A company's need for corporate real estate is driven in large part by both its current and planned physical requirements. Space needs can change dramatically over time with such changes driven by a variety of factors including growth/contraction plans, potential acquisitions, productivity improvements, and physical obsolescence of space. Further, local demographics may change needs for particular locations. These issues will vary significantly from company to company and perhaps even

on a property type by property type basis. The following examples help illustrate the diversity of potential issues based on a company's operations:

Example 1—Retail company

A retail company typically requires several different types of property for its operations including (i) store locations, (ii) warehouse locations and (iii) key corporate offices in central business districts.

Example 2—Bank

A bank typically requires several different types of property for their operations including (i) bank branches, (ii) processing operations (often in fungible office space in suburban markets) and (iii) key corporate offices in central business districts.

Generally, a company is more likely to lease real estate when its long-term property needs are unclear, operational flexibility is highly desirable and expected access to acceptable alternatives is good. Leasing has also historically carried the added advantage of providing companies with a form of off-balance sheet financing. Conversely, a company is more likely to buy when the company's long-term property needs are clear, the need for specific properties are expected to be stable and long-term, specific assets are needed and there are concerns with respect to the availability of acceptable alternatives.

Of course, there are many operational reasons why companies rent rather than own that may be unrelated to the accounting or even to the economics. One such reason frequently cited is that leasing allows tenants to avail themselves of professional property management. Does a bank, for example, want to maintain a staff of engineers, maintenance or other personnel necessary to manage the day-to-day issues surrounding management of real estate? In these circumstances, we may begin to see an expansion of service options that may allow incentivized property management to be done on a contract basis.

Overriding operational considerations is often the impact of market practice or practical availability. Certain types of properties (e.g., retail store locations) may be “unique” and not generally available for purchase, whereas commercial office space may be more fungible and, in some cases, also available for purchase.

With the loss of off-balance sheet accounting, companies that presently lease may instead opt to own. We have already begun to hear of potential purchase transactions involving single-tenant office buildings. It is possible that condominiumization of certain property types may also increase as a result of the proposed lease model. However, this trend will be affected by “why” the companies are leasing, as discussed previously. It is also likely to vary significantly by property type. For example, this is more likely to occur in more physically static situations such as individual floors or blocks of floors in large office buildings or with single-tenant retail sites, both of which may be functionally independent. It is less likely to occur with partial floors or in malls/strip centers which are not functionally independent and may frequently require reconfiguration of space to accommodate a different tenant mix.

As discussed previously, today, in many cases, companies “outsource” their corporate real estate lease administration because commercial real estate service providers provide this service relatively inexpensively (in order to gain access to more lucrative transaction activity such as leasing commissions) which is more cost effective than doing such administration in-house. However, the additional information needed to account for leases under the proposed lease model (such as the expectation of exercising of renewal options or projections of retail store sales and the impact of same on percentage rents to be paid) may be too sensitive to the company’s lease negotiating position to allow such interested parties to have the necessary access to the information in order to prepare the required accounting documentation.

Economic issues

Recent economic turmoil has significantly impacted property values, and market rents, in many cases, have declined dramatically. Vacancy rates in some property

types and markets are rising—sometimes significantly, but not uniformly across markets. Further, today many landlords are struggling with declining cash flow from operations, liquidity issues and debt maturities. As a consequence, landlords may be more willing to discuss asset sales and lease modifications—sometimes trading a lower rent in exchange for a longer lease.

The current environment presents both potential challenges and opportunities for users of corporate real estate. Current rents being paid pursuant to existing leases may be significantly above current “market” asking rents and landlords will likely be resistant to changing current terms. In certain cases, opportunities to buy assets at favorable prices may exist, while in other cases, negotiating rent concessions currently or through “blend and extend” type transactions may yield lower “all-in” occupancy costs.

Financing issues

For many industries or individual companies financing options may be limited or expensive. As a result, leasing, historically, may have been the only option available, or, it may have been cheaper than other sources of financing available to the company.

However, depending upon the credit quality of the company, corporate real estate departments may now want to reconsider purchasing assets that were previously subject to a lease. When underwriting the amount and terms of a commercial mortgage to a landlord, lenders will consider factors such as debt yields, coverage ratios, loan-to-value, the length of lease terms, likelihood of renewal and credit quality of the tenant or tenants occupying the property. In some cases, the landlord cannot effectively fund property improvements necessary for the current operation of the property. A corporate real estate user may have a better credit profile and lower cost of capital as compared to a particular landlord or to the “average” credit in a pool of tenants at a site. If the user is committed to a longer term use of the property, such user may benefit from obtaining financing using its own credit rating versus the landlord’s which may be lower as a result of current market difficulties.

Tax considerations

The proposed standard will reduce the difference in the accounting effects of leasing versus owning an asset, and companies may be more inclined to purchase assets rather than lease them. As companies take a fresh look at future real estate investment decisions and model the proposed accounting standard for existing leases, they may re-evaluate previous decisions or identify assets that no longer meet their needs. While the proposed accounting standard is unlikely in and of itself to cause significant disposition of assets, such disposition may be the result of reexamining the portfolio.

Federal and state tax considerations often played a significant role in many corporate real estate strategic decisions. A clear understanding of the tax motivation and implications for both of the counter-parties is critical as these factors may significantly affect the pricing as well as the range of transactions the parties may be willing to consider. In addition, the economic issues affecting either side of a transaction may have radically changed since the time when the decisions were first made. A company with net operating loss carryovers may be more willing to undertake substantial restructuring. One with expiring capital loss carryovers may be seeking opportunities to generate gains. Tax sensitive or tax oriented transactions by entities with significant owned real estate are generating more interest once again—including sale-leasebacks, joint ventures, spin-offs and REIT conversion transactions.

For state income tax purposes, business income of a company is apportioned among the states by means of an apportionment formula. For states that utilize a property factor in the apportionment formula, the proposed lease standard may impact the amount of business income apportioned to a state. In general, a property factor includes all real and tangible personal property owned or leased by the company and used during the tax period in the regular course of business. In most states, property owned by a taxpayer is valued at its original cost and property leased by the taxpayer is valued typically at eight times its net annual rental rate. Certain states' tax codes provide that federal income tax rules apply when determining the property factor. Others, such as New Jersey, do not follow the federal income tax treatment and determine property factor values based on book value. Companies doing business in these states may have historically used financial statement rent expense when

calculating the annual rental rate. In such instances, the proposed change in lease accounting may impact the calculation of the property factor.

State franchise/net worth taxes may also be impacted by a change in the leasing standard. Certain states, such as Illinois, determine the value of a company for franchise tax purposes using Generally Accepted Accounting Principles. In addition, this value may be apportioned to the state by use of a property factor, which is also calculated under GAAP principles. As a result, net worth taxes in certain states may increase as a result of the increased value of property as reflected on the balance sheet.

There may be additional state and local tax issues associated with the proposed lease standard, such as sales tax or property tax consequences. Companies will need to evaluate the unique tax provisions found in each state, and locality, to determine the various consequences to their particular case due to the proposed leasing standard.

The proposed lease accounting model may have other impacts on the tax treatment of leasing transactions, as tax accounting for leasing is often based on accounting principles in many jurisdictions outside the United States. Given that there is no uniform leasing concept for tax purposes, the effect of the proposed lease accounting model will vary significantly, depending on the jurisdiction.

Items that may be impacted include the applicable depreciation rules, specific rules limiting the tax deductibility of interest (for example, thin capitalization rules, percentage of EBITDA rules), existing transfer pricing agreements, sales/indirect taxes and existing leasing tax structures (in territory and cross-border). A reassessment of existing and proposed leasing structures should be performed to ensure continued tax benefits and management of tax risks.

Even where tax does not follow the proposed lease accounting model (like in the United States), management may see an increase in the challenges of managing and accounting for newly originated temporary differences in the financial statements.

Timely assessment and management of the potential tax impact will help optimize the tax position, by enabling entities to seek possible opportunities and/or reduce any tax exposures.

Regulatory issues

In some cases, the decision to lease was driven by regulatory issues particular to certain industries. For example, reimbursement rates paid on some government contracts are based on GAAP reporting. Today, for some contracts, the government will reimburse 100% of the cost of rent but does not reimburse for capital related items such as interest and amortization/depreciation of owned real estate. With the proposed elimination of the operating lease model, government contracts and/or reimbursement rules may need to be modified to ensure that the economics of the arrangement continue.

Since the standard is still under discussion, additional regulatory effects may emerge when the standard is final and its effects are better understood. What is uncertain at this point is how regulatory agencies will come to grips with how this change will impact risk-based capital requirements and other key regulatory metrics. In light of the balance sheet gross-up and acceleration of expenses relative to straight-line rent expense typical of an operating lease today, the effect of the change could be very significant to banks/broker dealers and other regulated entities whose capital ratios and/or other metrics are closely monitored and which would be adversely affected in many cases if computed under the proposed model without adjustments.

Intercompany issues

Many heavy corporate real estate users use a central real estate “holding entity” for owned and “leased in” property and then provide for intercompany charges to the other consolidated subsidiaries. In some cases, the structures have been created to take advantage of beneficial pricing (allowing companies to aggregate subsidiary needs to take bigger spaces, obtain operating synergies and to negotiate better terms) and for operational ease (allowing corporations with multiple subsidiaries to be flexible in allocating space between these units) or are driven by tax considerations (e.g., private REITs with beneficial state tax impacts). In some cases, companies executed intercompany leases, but, in others, no formal arrangement existed and costs were allocated through an intercompany expense charge. Under the proposed lease standards, these intercompany transactions will need to be reflected on the separate company’s books and the documentation of the arrangement is likely to be much more important

since it will drive the value of assets and associated liabilities for entities reporting on a stand-alone basis.

Governance and budgetary issues

Some historical decisions to lease versus buy may have been driven by approval protocols and budgetary factors. For example, where a company is growing rapidly it might have been faster and more efficient to execute a lease of real estate or equipment rather than going through the process to approve the purchase of a capital asset. In addition, internal budgeting may have led to a leasing bias since the upfront cash outlay is much lower than a purchase. If the approval rules follow the new lease model, an operating lease may now need the same level of approval as an outright purchase.

Managing corporate real estate

In many organizations today, the corporate real estate department is viewed as more of an administrative function or cost center rather than a part of a strategic function or a competitive advantage. Further, corporate real estate departments are frequently undermanned and often do not have the infrastructure or systems to effectively track and manage the real estate for which they are responsible.

Further, many companies have grown larger through acquisition, and legacy systems are often “balkanized” thus limiting management’s ability to understand and manage real estate on a company-wide or even country-wide basis. Such systems are rarely optimal for a company’s current operations nor are they fully integrated into the larger enterprise-wide systems, including accounting and reporting. In addition, because of the length of a typical real estate lease, current management may not be aware of the original rationale for specific decisions, some of which may no longer exist due to changing circumstances.

In some cases, corporate real estate departments may have the responsibility for tracking the real estate but not enough resources and focus to identify and manage excess capacity, identify and seek reimbursement for overcharges for lease operating costs (e.g., CAM and bill back overcharges) and/or minimize other cash real estate occupancy costs. Finally, for many companies, existing

tracking systems are informal, incomplete or inaccurate. These “tracking systems” might be nothing more than a drawer for storing copies of leases, a notebook containing lease abstracts, Excel spreadsheets and non-integrated or out-of-date software applications.

With respect to asset management systems, today, many companies are still accounting for their leases of corporate real estate using Excel and the accounts payable systems with no formal corporate real estate asset management systems. Even for the more sophisticated corporate real estate groups that have asset management systems, these systems are freestanding, with no integration with the company’s accounting systems. Accounting for leases under the proposed lease standard will require significant changes to existing information systems as well as new processes and controls. In many cases the information necessary to make the various decisions, estimates and periodic re-measurements has not previously been reported to accounting or treasury on a timely basis (such as changing expectation of renewals or changing expectations on future contingent rents). For high volume corporate real estate users, from a long-term sustainability perspective, it will likely be a necessity that such systems/processes be largely automated and fully integrated into the companies control structure and accounting systems. Given all of the above, these changes will necessitate a potentially significant cultural change as well as an operational one.

Internal controls and processes

Many entities in the past have not needed robust processes and controls for leases other than around their initial classification. In addition to eliminating operating lease accounting, existing lessee accounting models (absent a modification or exercise of an extension) did not require leases to be periodically revisited. The proposed new standard would require that leases should be re-measured for changes in estimates (for example, for changes in expected lease term or expected contingent rent payment) and will require entities to (re)design processes and controls to ensure proper management and accounting of all lease agreements.

Initial recording on balance sheet and annual reassessment of lease terms and payment estimates may require significant and complex changes to existing processes and internal controls, including support for significant management assumptions. Monitoring and evaluating the estimates and updating the balances may also require more resources than current accounting.

Timely assessment and management of the impact on processes, controls and resource requirements will help control your business and reduce reporting risks.

IT and lease accounting systems

IT and lease accounting systems in the marketplace are based on the existing risks and rewards concept; they will need to be modified to the proposed right-of-use concept. Obviously, systems designed to meet the needs of this potential new pronouncement have not yet been created and must be developed. Lessees will have to account for and manage lease agreements differently (including existing operating lease agreements). They may need to implement contract management systems for lease agreements and integrate these with existing accounting systems. Lessees will need to identify and implement IT and accounting solutions that meet their future needs.

Lessees may expect lessors to provide them with the necessary information to comply with the proposed standard. However, lessors may not have, or may be unwilling to provide, data required by lessees. Consequently, lessees will need to capture such information themselves and may, therefore, need to modify their systems.

Timely assessment and management of the impact on IT and lease accounting systems will help reduce business and reporting risks. We understand that some of the ERP systems are in the process of evaluating upgrades and solutions that will allow for an integration of the accounting for the new lease project and potential controls thereon, however, such discussions are only at their conceptual and planning phases pending the issuance of the Exposure Draft.

Financial reporting and impact on ratios

The financial statements will require restatement for the effect of the changes. The effects of the proposed lease accounting model should be clearly communicated to analysts and other stakeholders in advance.

Ongoing accounting for leases may require incremental effort and resources as a result of an increase in the volume of leases recognized on balance sheet; there is also likely to be a need for regular reassessment of the lease term, contingent rentals, residual value guarantees, or the impact of purchase options.

The impact of change will not be restricted to external reporting; internal reporting information, including financial budgets and forecasts, will also be affected.

The proposed lease model will change both balance sheet and income statement presentation. Leverage and capital ratios may suffer from the gross-up of balance sheets. Rent expense will be replaced by depreciation and interest expense. In addition, the expense recognition pattern may change significantly. This will negatively impact some performance measures, such as interest cover, but improve others, such as EBIT/ EBITDA and cash flow from operations, with no change in the underlying cash flows or business activity. In addition, continuous re-measurement will increase volatility of key ratios.

Timely assessment of the proposal's impact on covenants and financing agreements will enable management to start discussions with banks, rating agencies, financial analysts and other users of the entity's financial data. Entities anticipating capital market transactions should consider the effects on their leverage ratios. Other agreements based on (entity-specific) key performance indicators will require reassessment and, potentially, adjustment (for example, compensation agreements).

The opportunity

The last five years have seen a host of changes facing corporate real estate organizations. From cost management to outsourcing, from systems changes to designing the workplace of the future, the role of the corporate real estate department has never been more complex. Nevertheless, the role of corporate real estate as a strategic function within the enterprise has been spotty at best. Simply put, many Senior Executives or Boards of Directors have not viewed their corporate real estate departments as a material element in driving the success of an organization. At best, corporate real estate departments are viewed as a necessary, but largely as an administrative function, having little bearing on the overall success or failure of the company. Given the current state of play—some would say “who would think otherwise?”

By some estimates, real estate leasing accounts for nearly two-thirds (2/3) of all leasing activity (estimated at over one trillion dollars) by U.S. companies. As part of our discussions with client and industry representatives around the changes which may be coming as part of

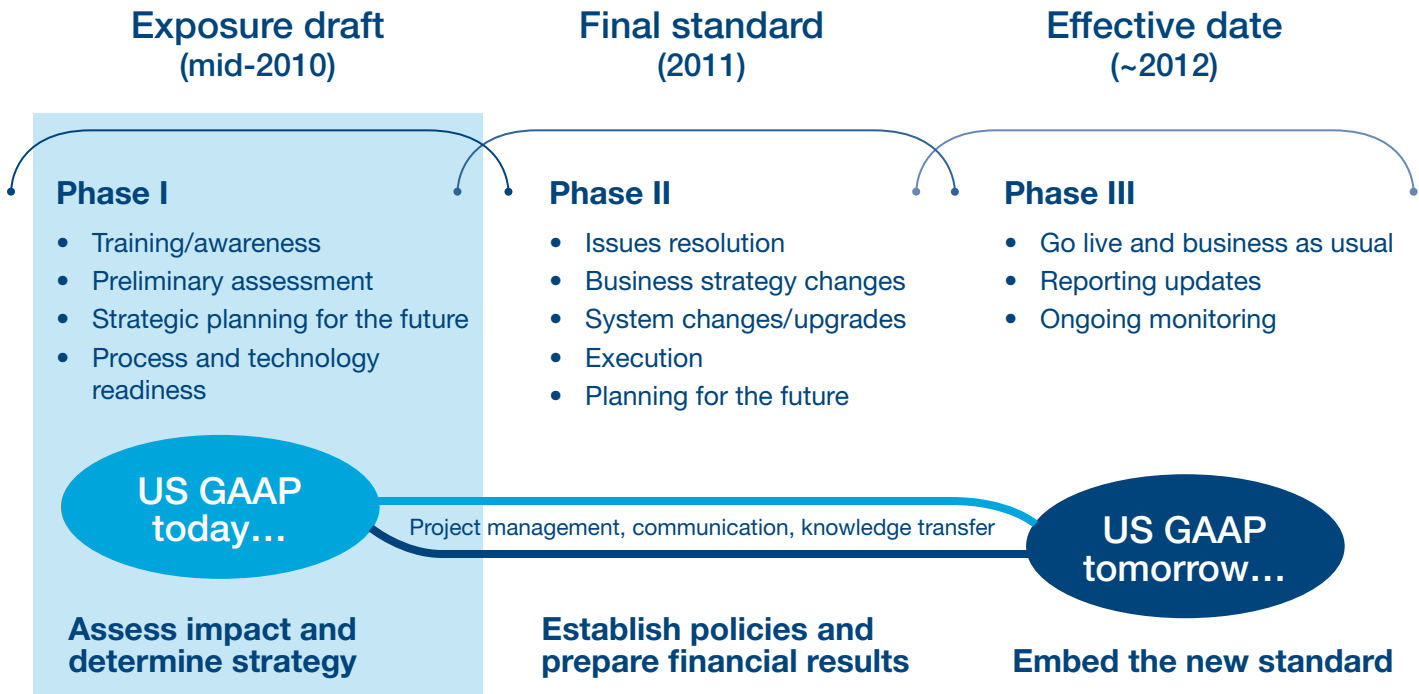
the joint FASB/IASB lease accounting project, we are beginning to see senior management at many companies target their corporate real estate strategy and operations for a major renovation and update in order to prepare for the new GAAP requirements, as well as to be more nimble in the current economic climate.

The proposed lease standard is not expected to allow for grandfathering of existing leases. Management will need to catalogue existing leases and gather data about lease term, renewal options and payments in order to measure the amounts to be included on balance sheet. Gathering and analyzing the information could take considerable time and effort, depending on the number of leases, the inception dates and the availability of records. International operations could make this not only more voluminous but could introduce additional issues such as contracts in different languages and leases affected by local regulations. In many cases, original records may be difficult to find or may not be available. In addition, companies with international operations may need to deal with leases written in different languages and with the potential impact of local statutes in applying the standard. For example, in France certain local statutes provide the lessee with an automatic rent controlled renewal option irrespective of whether one is contained in the lease agreement itself.

While the adoption of the new standard remains at least 18 months away, organizations are well-advised to begin considering the impact of these changes now, and to put into motion the steps needed to prepare your organization for the change. Amongst the technical accounts, operational, and system changes outlined in this document, we predict that changes to your Corporate Real Estate role will also be needed, and the lease accounting changes being proposed should provide the “Catalyst to Change Corporate Real Estate.” Beginning the process early would ensure that implementation of a future standard is orderly and well-controlled and that data on new leases written before implementation of the changes is captured from the outset. In addition, it may allow entities to consider potential adoption strategies, negotiation strategy changes for new leases and potentially to renegotiate existing agreements in order to reduce the impact of adoption.

The chart that follows depicts a potential transition plan with respect to evaluating the effects of the proposed lease model. Incremental corporate real estate strategy and systems changes would be done concurrently with this plan.

Lease project timeline/path forward



How can PwC help?

PwC has multi-disciplinary teams of specialists who can assist you with all aspects of your corporate real estate journey.

Real estate strategy and accounting advisory

- Training, planning and implementation assistance with regard to new lease standard
- Analysis of needs and market trends
- Analysis of, or assistance with, evaluating financial and strategic impact of new lease project

Tax and transaction support

- Analysis of tax implications and structuring opportunities with respect to new lease standard
- Sale-leaseback transactions
- REIT spin-offs of corporate real estate to unlock shareholder value
- Federal and state tax planning transactions

Systems and processes

- Process/control change consulting/implementation planning with respect to impact of new lease project
- Strategic information systems planning
- Gap analysis & system selection
- Technology integration & implementation

Operational effectiveness and cost containment

- Lease expense “audits” for potential recovery
- Process re-design & leading practices in corporate real estate
- Benchmarking and performance monitoring
- Spend analysis, strategic sourcing, outsourcing effectiveness
- Operational & organizational effectiveness

Valuation/market analysis

- Real estate and lease portfolio valuation
- Market studies
- Valuation analyses in conjunction with accounting requirements (i.e., FAS 141)

If you would like further information on the proposed lease accounting model or assistance in determining how it might affect your business, please speak to your regular PwC contact. A list of PwC contacts has also been provided on the back cover of this publication.

Appendix—Detailed discussion of lease project from lessee’s perspective

Status of the joint lease project

In this Appendix, we will summarize the current direction of the project as of April 30, 2010 based on the Discussion Paper issued in March of 2009 as well as conclusions reached by the Boards (FASB and IASB) as part of their redeliberations of particular issues since. We expect that the actual Exposure Draft that will be issued will be consistent with the concepts contained herein, but differences in the final Exposure Draft may arise, and further differences may arise as the Boards redeliberate the Exposure Draft in light of comment letters they receive on the Exposure Draft.

Background

Leasing is an important and widely-used source of financing. It enables entities, from start-ups to multinationals, to acquire the right to use property, plant, and equipment without making large initial cash outlays.

Entities currently account for leases as operating leases or finance leases. Lease classification is based on complex rules. Though many operating leases provide nearly the same risks and rewards as outright ownership, neither the leased asset nor the obligation to pay for it is recorded on the balance sheet. Rather, rent expense is recorded on the income statement on a straight-line basis throughout the lease term under current GAAP.

Many observers have long believed that the current lease model is not consistent with the current conceptual framework, which provides the underpinnings for international accounting rules. They argue that current guidance allows lessees to structure lease transactions to result in operating lease classification. Critics also

point out that the current standards permit something as illogical, for example, as a commercial airline company to recognize no airplanes on its balance sheet.

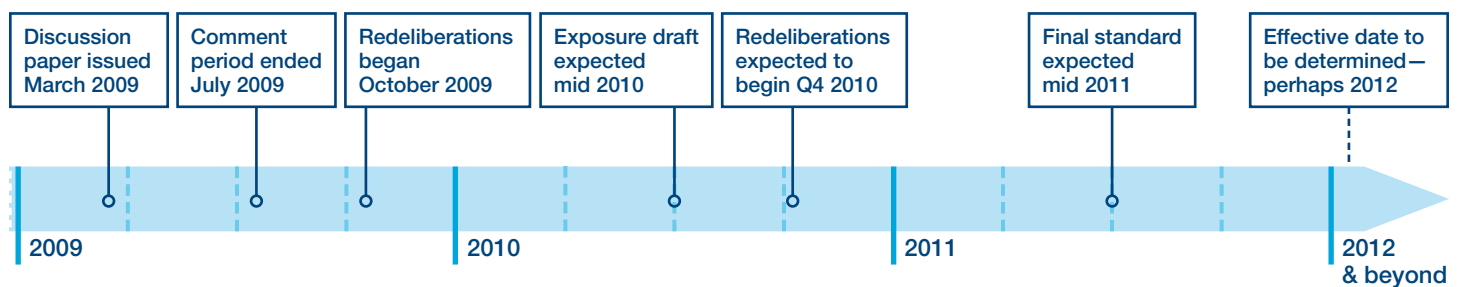
In June 2005, the Securities and Exchange Commission (SEC) issued its *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Users*. One of the significant recommendations in this report was that existing lease standards needed to be rewritten.

As part of their global convergence process, the Boards have been working to create a single, comparable, worldwide leasing standard. The project was intended to build on previous work contained in the 1999/2000 white paper entitled “G4+1 Special Report, *Leases: Implementation of a New Approach*.” The Boards issued a joint discussion paper in March 2009. They currently expect to release an Exposure Draft in Q2 2010 and a final standard around a year later.

The project was initially expected to cover only lessee accounting with lessor accounting to be addressed concurrently with the joint project on Revenue Recognition. However, in response to concerns raised that subsequent consideration of lessor accounting could result in changes to the lessee model, the Boards now expect the final standard to address the overall lessor model but potentially have a different adoption date.

The time line

The project time line and reasonable reaction time periods for tenants/landlords to evaluate potential impacts are as follows:



Key provisions

We will discuss the following expected key provisions of the standard and provide an example of the impact of on a real estate user (lessee) in a hypothetical lease scenario.

Scope

The Boards have preliminarily determined that the scope of any proposed standard will include leases of property, plant and equipment and will not include leases of intangible assets. The Boards also preliminarily decided to exclude from the scope: (1) leases to explore for or use natural resources (such as minerals, oil, and natural gas), and (2) leases of biological assets. The scope of a proposed standard will therefore broadly align with current IFRS.

PwC observation: Similar to other standards, the proposed lease standard would not apply to immaterial items. Although a single item might be immaterial, items of a similar nature might be material in the aggregate (that is, one computer lease might be immaterial, but 10,000 computer leases might be material). For leases determined to be immaterial to the financial statements in the aggregate, management may consider developing a policy similar to commonly used property and equipment capitalization policies.

Short-term leases and non-core assets

The Boards considered the potential exclusion of short-term leases and leases of non-core assets. Factors included in their considerations were the cost of applying the model, the difficulty in defining non-core assets, and the potential structuring opportunity that an exclusion could create. They tentatively decided not to exclude short-term leases or leases of non-core assets because these leases may give rise to material assets and liabilities and, if so, excluding them would run counter to the Boards' objective of bringing the rights and obligations on the balance sheet.

Although the Boards decided not to grant an exclusion for short-term leases, they reached a preliminary decision to ease the burden in accounting for them. For leases with a *maximum possible* term (including all extension options) of

less than 12 months, lessees could use a simplified form of lease accounting: the lessee would recognize a lease asset and liability equal to the gross payments remaining on each lease.

PwC observation: Because of the short duration of the leases that qualify for the simplified approach, the time value of money associated with these short-term leases would be ignored, as a practical expedient.

Lessee accounting

The basic model

The Boards are expected to propose a right-of-use model for lessee accounting. This model requires the lessee to recognize an asset representing its "right to use" the leased item for the lease term and a corresponding liability for the obligation to pay rentals. Under this approach, all leases would be accounted for in a similar manner; the classifications of finance and operating leases used today would be eliminated.

The Boards believe the right-of-use model is the most consistent with their conceptual frameworks and increases the transparency of lease accounting. Because leases are commonly viewed as a form of financing, the obligations recognized on the balance sheet under the right-of-use approach would be consistent with how businesses reflect other financing arrangements.

PwC observation: The right-of-use model might change how entities negotiate leases, and it might affect lease-versus-buy decisions. However, we believe leasing will continue for a variety of business reasons:

- Leasing provides more flexibility than outright ownership;
- Certain leasing structures are more tax-efficient than direct ownership; and
- Leasing often provides effective financing to entities whose financing options are otherwise limited. In addition, for substantial items, such as real estate, leasing is expected to continue as a viable option because many entities prefer not to own these types of assets.

- Leasing may be more appropriate for space users who occupy only a small portion of a larger facility (e.g., tenant in a regional mall) or for a period which is substantially shorter than the useful life of the asset (e.g., 5 years for an office building with a useful life of 40 years or more)
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Initial measurement

Lessees initially would measure the right-of-use asset and the obligation to pay rentals at ‘cost’. Cost is defined as the present value of the lease payments, including initial direct costs incurred by the lessee. The Boards have defined initial direct costs as incremental costs directly attributable to negotiating and arranging a lease. They have directed their staffs to provide additional guidance to illustrate which costs could be considered initial direct costs.

Present values would be determined using the lessee’s incremental borrowing rate as the discount rate. If the rate the lessor is charging to the lessee is readily determinable, this rate can be used in place of the incremental borrowing rate.

PwC observation: The Boards have shown a preference for the use of the incremental borrowing rate recognizing that, for real estate and other forms of leases currently treated as operating leases, the lessee will not often be in a position to determine the interest rate the lessor is charging to the lessee. Nevertheless, in circumstances where it is easily determined (such as full payout leases and hire purchase transactions) the interest rate the lessor is charging to the lessee may be used as a practical proxy for the incremental borrowing rate.

“Gross” versus “Net” leases—period costs to be excluded

“Executory costs” are frequently included in the quoted lease terms (especially for real estate) and need to be removed from the lease payments that are used to generate the value of the initial leased asset and liability. Executory costs is an accounting term used to describe such things as real estate taxes, utility expense, maintenance, property management, snow removal, landscaping, security and cleaning that may be included in the lease payments. These costs are operating period

costs and should be reflected in the period incurred but are expected to be excluded from the rent in applying the proposed lease accounting model. There are several different types of leases that are common and each may have some unique issues to deal with. Some of these are described below:

- **Net lease**—These types of leases are common for retail/industrial property and single-tenant property where the tenant is either billed by the lessor for executory costs incurred (on a pro rata basis for multi-tenant properties) or such costs are paid directly by the tenant. In such leases the tenant bears the risk of all the upside/downside with respect to changes in the executory costs.
- **Base year lease**—These leases are common for office property where the tenant’s rent is set during the first year of the lease, i.e., the “base year,” which includes executory costs (on a pro rata basis for multi-tenant leases). In subsequent years, the tenant pays additional amounts for executory costs to the extent they exceed the tenant’s pro rata share of the aggregate of those expenses in the “base year.” In these leases, tenants bear all the aggregate downside in the case of rising prices and the lessor gets any benefits of aggregate efficiencies that reduce overall costs.
- **Gross lease**—Gross leases have historically been very simple. The quoted base rent includes all executory costs. In such leases, the tenant bears the risk of all the upside/downside associated with cost changes. In many cases, especially for real estate, the tenant neither knows nor (previously) cared what these executory costs are—their focus is solely on the all-in cost of occupancy.

PwC observation: Stripping out executory costs was not significant in many cases under the current lease accounting model but will become significant under the proposed leasing model. Therefore, management may need to obtain information with respect to executory costs from landlords or to find ways of estimating them.

Subsequent measurement

The Boards have preliminarily agreed that the right-of-use asset should be subsequently measured at amortized

cost. The expense recorded would be presented as amortization expense rather than rent expense. The lessee's obligation to pay rentals would also be subsequently measured at amortized cost using the effective interest rate method under which payments would be allocated between principal and interest over the lease term. Interest expense determined under that method would be higher in the early years of a lease compared to the current straight-line treatment for rental expense under an operating lease.

Lease term

Under existing standards, optional periods are considered part of the lease term if the lessee concludes at lease inception that it is 'reasonably certain' to exercise the right to renew the lease. Under the right-of-use model, lessees would be required to estimate the ultimate lease term and periodically reassess that estimate. A detailed examination of every lease at each reporting date would not be required. A lease's term would be re-examined only if changes in facts and circumstances indicate that a revision may be needed.

The lease term is proposed to be defined as the longest possible term more likely than not to occur. In estimating the lease term, all relevant factors should be considered, including intentions and past practices. For example, consider a lease with a non-cancellable five-year term and two five-year renewal options. The minimum contractual term of five years is more likely than not to occur (the probability is 100 per cent that the lease will cover at least the five-year period). The lessee would also need to consider whether the 10- or 15-year terms available as a result of the renewal options are more likely than not to occur. Once the lessee has determined which lease terms are more likely than not to occur, the longest of those terms would be the lease term used to account for the lease.

Purchase options

The Boards tentatively decided that purchase options would be accounted for similar to the accounting for options to extend a lease and should not be recognized as separate assets. A lessee would therefore need to estimate whether the purchase option is more likely than not to be exercised and revisit this judgment if facts and circumstances change.

Contingent cash flows

Under existing standards, contingent rents are generally recognized as expenses in the period they are incurred. The right-of-use model would require that the initial measurement of the obligation to pay rentals include contingent cash flows, such as 'turnover rent', increases in rents based on changes in an index (such as CPI), percentage rents that appear in many retail leases, and residual value guarantees.

The Boards have preliminarily agreed to use a probability weighted estimate of contingent payments with the clarification that a lessee does not have to consider every possible scenario. Thus, this technique encourages the lessee to consider possible outcomes.

Changes in estimates and remeasurements

The Boards tentatively decided that lessees would be required to reassess estimates of lease term and contingent cash flows as warranted by changes in facts and circumstances. Subsequent measurement of the lease obligation would reflect all such changes in estimate. Changes in the lessee's obligation due to a reassessment of the lease term would be recognized through an adjustment of the right-of-use asset.

Regarding changes in estimated contingent cash flows, the Boards have tentatively decided on a mixed model. Where changes in amounts payable under contingent cash flow arrangements are based on current or prior period events or activities, those changes should be recognized in the income statement. All other changes would be recognized as an adjustment to the lessee's right-of-use asset. For example, consider a lessee that enters into a 10-year lease agreement that includes rental payments based on a percentage of sales. During the second year of the lease, the lessee determines that the original estimated sales figures require updating. Adjustments in the obligation arising from the true-up of sales for years one and two would be recognized in profit and loss. Changes in the obligation from the updated forecast in sales in years three to 10 would be recognized as an adjustment to the right-of-use asset.

The Boards considered whether the discount rate should be updated when a remeasurement is required due to a change in estimated term or contingent cash flows. However, it tentatively agreed that the original discount rate should be used as the discount rate throughout the term of the lease. The only exception would be a lease with rentals contingent on variable reference interest rates; for all other leases, the accounting would be consistent with that of a fixed rate borrowing.

PwC observation: The requirement to reassess these estimates entails significant incremental effort compared to the current model under which lease accounting is set at inception and revisited only if there is a modification of the lease terms. In addition, it may be necessary to invest in information systems that capture and catalogue relevant information, and support reassessing lease terms and payment estimates as facts and circumstances change.

Example

An example illustrating the accounting implications on the income statement and the balance sheet, from the lessee's perspective, is included on the next page:

Simple Lease Example (Lessee):

Lease terms and assumptions:

Lease commenced on 1/1/xx00
 Square feet 100,000
 Annual initial rent per square ft \$ 20.00 (Paid monthly)
 Initial annual rent \$ 2,000,000 (000's omitted)
 Annual escalation 2.0%
 Assumed incremental borrowing rate 7.00% (10 year rate)
 Triple net lease—executory costs paid separately
 No extension options
 No purchase options
 No residual value guarantees
 No contingent rent of any kind

(000's omitted)

	As of December 31,										Total	
	XX01	XX02	XX03	XX04	XX05	XX06	XX07	XX08	XX09	XX10		
Balance sheet implications												
Right to use asset	\$15,540	\$12,432	\$10,878	\$9,324	\$7,770	\$6,216	\$4,662	\$3,108	\$1,554	\$0		
Lease obligation	(\$15,540)	(\$13,547)	(\$12,377)	(\$11,080)	(\$9,646)	(\$8,062)	(\$6,319)	(\$4,404)	(\$2,302)	\$0		
Income statement implications	For the year ended December 31,											
Proposed model:												
Amortization/depreciation of right to use asset	\$ 1,554	\$ 1,554	\$ 1,554	\$ 1,554	\$ 1,554	\$ 1,554	\$ 1,554	\$ 1,554	\$ 1,554	\$ 1,554	\$ 1,554	\$ 15,540
Interest expense on lease obligation	1,058	989	911	825	730	625	509	382	242	87		6,358
Combined expenses related to lease	\$ 2,612	\$ 2,543	\$ 2,465	\$ 2,379	\$ 2,284	\$ 2,179	\$ 2,063	\$ 1,936	\$ 1,796	\$ 1,641		\$ 21,898
Current accounting model (straight line)												
	\$ 2,190	\$ 2,190	\$ 2,190	\$ 2,190	\$ 2,190	\$ 2,190	\$ 2,190	\$ 2,190	\$ 2,190	\$ 2,190	\$ 2,190	\$ 21,899
A - B	\$ 422	\$ 353	\$ 275	\$ 189	\$ 94	(\$ 11)	(\$ 127)	(\$ 254)	(\$ 394)	(\$ 548)		
Difference—current period	422	775	1,050	1,240	1,334	1,323	1,196	942	548	(0)		
Difference cumulative	\$ 2,000	\$ 2,040	\$ 2,081	\$ 2,122	\$ 2,165	\$ 2,208	\$ 2,252	\$ 2,297	\$ 2,343	\$ 2,390		
Cash (paid in monthly installments)	2,000	4,040	6,121	8,243	10,408	12,616	14,869	17,166	19,509	21,899		
Cumulative cash												

PwC observations:

- Right to use asset amortizes over the term of the lease.
- Lease obligation acts like a mortgage, each payment is applied to “Principal” and interest. Interest is higher in earlier years.
- Total expense is same over term of the lease.
- Combined expenses for new model is higher in the earlier years than both the current model and cash terms.
- Lease obligation exceeds net unamortized asset after day 1 until the end of the lease.
- Longer lease terms or lease terms with contingent rents (usually back ended from cash perspective) would have even more distortion to both current accounting models and cash terms.
- Example is for net lease and cash payments exclude executory costs. If base year or gross leases, executory costs would need to be removed from payments for leases accounting.

Other areas of difficulty

Sale and leaseback transactions

The Boards decided that a sale-leaseback transaction should be recorded as a sale and leaseback rather than a financing if it is determined that the underlying asset has been sold. An underlying asset has been sold if, at the end of the lease term, control of the underlying asset has been transferred and all but a trivial amount of the risks and benefits associated with the underlying asset has been transferred to the buyer/lessor. If the sale-leaseback transaction results in a sale of the underlying asset and both the sale and leaseback are at fair value, then gains/losses should not be deferred. If, however, the sale and leaseback are not at fair value, then the seller lessee should adjust the asset, liabilities, gains and losses to reflect current market rents.

Subleases

The Boards have decided that the lease-in would be accounted for under the lessee model and the lease-out under the lessor model. However, there may be some “netting” of parts of the two where there is overlap. The Boards have not finally decided on the lessor accounting model as yet—there are two models being discussed: a “performance obligation approach” and a “derecognition approach.” The Boards are expected to discuss both possible methods in the Exposure Draft, but select one in the final standard.

Presentation and disclosure

The Boards tentatively decided that a lessee would present its obligation to pay rents separately from other financial liabilities on the face of the balance sheet. The right-of-use asset would be presented with PP&E but separately from other assets that are owned but not leased. Amortization and interest expense would be separated from other amortization and interest expense either on the face of the income statement or in the notes of the financial statements. The Boards will ask for comments in the Exposure Draft as to whether the items discussed herein should be presented on the face of the financial statements or in the notes to the financial statements. Both cash repayments and interest payments would be classified in the cash flow statement financing activities separately in the statement of cash flows.

PwC observation: The Boards generally require disclosure of key significant contract terms, estimates and assumptions, often including sensitivity analyses. Because of the increased emphasis on estimates in the model, relative to current standards, the disclosure requirements are expanded significantly.

Transition and effective date

The proposed leasing standard would be applied by a lessee by recognizing an obligation to pay rentals and a right-of-use asset for all outstanding leases at the transition date. The obligation would be measured at the present value of the remaining lease payments, discounted using the lessee’s incremental borrowing rate on the transition date. The right-of-use asset would be measured on the same basis as the liability, subject to any adjustments required to reflect impairment. Additional adjustments for prepaid or accrued rents should be made when lease payments are uneven over the lease term.

The Boards have tentatively decided to make an exception for simple leases currently accounted for as finance/capital leases that do not include contingent rents, residual value guarantees or options to extend the lease term. Finance/capital leases entered into prior to the transition date that meet this exception would continue to follow the existing finance/capital lease accounting principles. This simplified approach to transition reflects the reality that, for many long-term leases, the information needed to adopt the proposed standard retrospectively may no longer be available.

PwC observation: The lack of grandfathering for existing leases will require an extensive data-gathering exercise to take an inventory of all contracts and then, for each, capture information about lease term, renewal options, and fixed and contingent payments. Depending on the number of leases, the inception dates and the records available, gathering and analyzing the information could take considerable time and effort. Beginning the process early will ensure that implementation of the future standard is orderly and well-controlled. Management may also want to bear in mind the proposed model when negotiating lease contracts between now and the effective date of the new standard.

The Boards expect to issue an Exposure Draft by June 2010 and a final standard in mid-2011. The Boards have not discussed the effective date of the standard, but presumably it would be no earlier than 2012.

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