

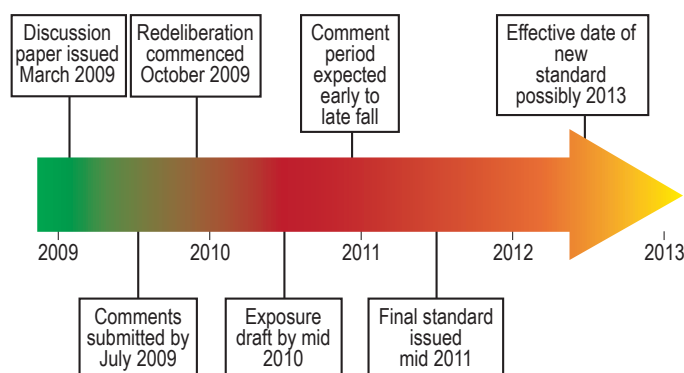
March 2010

## Impact on corporate real estate portfolios comes into focus as the future of lease accounting rules takes shape

A new paradigm for lease accounting is about to be released and it will impact every business whether public or private. By June of 2010, the U.S. Financial Accounting Standards Board (FASB) and its counterpart, the International Accounting Standards Board (IASB), will issue an Exposure Draft of lease accounting changes. The proposals will be dramatic and accounting for all leases of real estate and equipment, existing and new, will be changed.

The Exposure Draft will follow the outline of a discussion paper issued by the Boards in March 2009 that will capitalize all leases on the balance sheet by recognizing a lessee's rights and obligations. Rather than choosing one of two methods to classify leases today—as operating or capital leases—the new approach will cause companies to recognize an asset representing its right to use leased property and a liability for its obligation to pay rent and other amounts. The Boards expect to release a final standard on lease accounting in mid-2011. The effective date of the standard would likely be no earlier than 2012, or possibly 2013.

Figure 1: Timeline



As the reality of new lease accounting rules approaches, corporate real estate directors have gained a greater understanding of the changes and what they will mean to their companies. Many, however, still face the daunting challenge of preparing their existing lease portfolio and reassessing the criteria for structuring effective leases going forward.

The pressure to revamp the three-decade-old leasing standard is driven by the perceived lack of transparency around off-balance sheet obligations and the complexity of current lease accounting. When the project on lease accounting was adopted in 2006, U.S. companies were estimated to have a capitalized equivalent of \$1.3 trillion in operating leases. A common rule of thumb is that 70 percent of operating leases represents real property.

### Details firming up

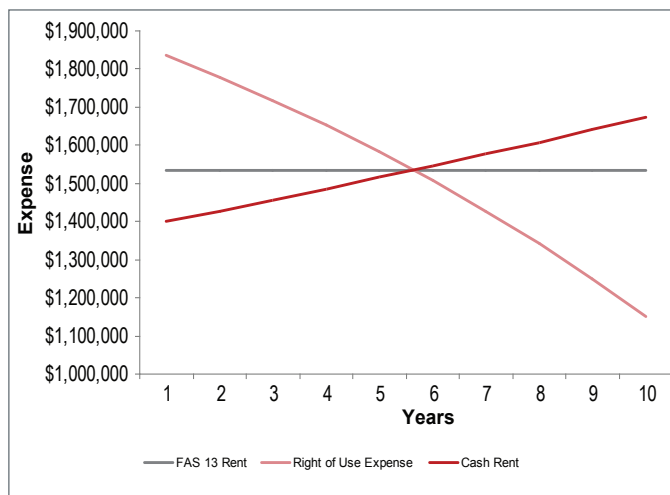
Moving ahead on their plans to implement the change, the Boards considered more than 300 comment letters on their preliminary views. Ongoing deliberations by the Boards since September 2009 provide detail and insight into what to expect in the new world order for leasing. Decisions made to date include:

- Capitalization of leases based upon the present value of lease obligations, discounted at the lessee's incremental borrowing rate
- Capitalized value to include base rent, but also an estimate of contingent rent and other expected payment amounts, and for the longest possible term more likely than not to occur which may include optional renewal periods
- Elimination of the distinction between operating leases and capital leases

- Change in pattern of rent expense from straight line to a method similar to capital leases which results in front-loading expenses
- Reassessment of leases in subsequent reporting periods triggered by changes in estimates of lease term and contingent rent, leading to an adjustment of the right-of-use asset
- Simplified accounting for leases less than 12 months
- Lessor accounting will recognize a lease receivable and corresponding liability for the lessor's performance obligation under the lease arrangement, leading to grossing up the balance sheet and income statement

Corporate real estate directors have become increasingly aware of the proposed changes and impact in the past year. When Jones Lang LaSalle and CoreNet Global surveyed the latter's U.S. members in 2009, many corporate real estate executives were hearing about the lease accounting change for the first time, and many more were only vaguely aware of its impact.

Figure 2: Comparison of rent expense



The expected effects from the new standard will be significant and include:

- Substantially larger balance sheets from reporting leased assets and lease obligations
- Higher reported initial occupancy expenses, as much as 20 percent, as straight-line rent expense is replaced by

amortization of the leased asset and high front-end interest expense (see figure 2)

- Pressure on existing borrowing agreements related to covenants for leverage ratios and earnings
- Greater complexity in reporting and investment in information systems—need for more data and judgment applied in evaluation; continuous periodic reassessment of estimates and potential remeasurement required
- Higher reported cash flow (EBITDA) as rent that was previously “above the line” is changed to interest expense and amortization

There are still major topics with a significant impact on corporate real estate yet to be addressed before issuance of the Exposure Draft in the second quarter 2010. In addition to the effective date for the new standard, these topics include treatment of:

- Subleases
- Sale-leasebacks
- Build-to-suit arrangements

## TOOLS FOR CHANGE

To help companies assess the financial impact of the new accounting rules, Jones Lang LaSalle has developed a lease capitalization calculator. Using the calculator, our corporate finance experts can provide a detailed analysis to help corporate real estate executives:

- Calculate capitalized amounts of leased assets and liabilities to go on balance sheet
- Generate new annual expense profile and compare to current expense
- Profile improvements to cash flow/EBITDA
- Run sensitivities to assumptions in discount rate, contingent rents and lease term
- Support decision-making in negotiation of lease terms and provisions
- Provide a baseline for potential peer analysis

### What to do now

Today, most executives are better informed and taking steps to prepare. A complete program to prepare for the new rules includes four essential components:

- Understand and quantify the impact
- Communicate with corporate treasury and accounting about the changes, decisions and reporting needs for the future
- Test how negotiated lease terms drive the balance sheet and operating expense
- Re-assess principles for lease vs. own decision-making

CRE executives who know their annual lease expenditure can quantify the impact without too much difficulty, and most have an ongoing dialogue with the finance team to determine the impact on the balance sheet and P&L. The challenge many face today is in determining how the rule change ought to affect lease decisions and structures going forward. Starting as soon as possible, major lease decisions should consider the impact of the new approach.

Fundamental questions arise when considering steps to minimize the financial reporting impact:

- Should a shorter lease term be negotiated?
- How does the accounting affect the lease vs. own decision? If an asset is going on the balance sheet, why not just own it?

As executives at major companies have become aware of the changes in lease accounting, they've used the proposed accounting changes to engage the C-suite and act as a strategic partner. The opportunity to affirm a company's goals around its occupancy strategy and use of corporate capital for real estate is beneficial.



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