

**REVISED EXPOSURE DRAFT ON
LEASE ACCOUNTING ISSUED:
BACK ON THE FRONT BURNER**

June 27, 2013



CBRE

ADMINISTRATIVE

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- Today's webcast is being recorded. A link will be sent out to all who registered.
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AGENDA

- Overview of Revised Exposure Draft
- What Can Be Done Now in Anticipation of the Proposed Changes
- Strategic Implications of the Proposed Changes
- Timeline: Where Do We Go From Here?



OVERVIEW OF REVISED EXPOSURE DRAFT

LEASE ACCOUNTING OVERHAUL

Problems with existing lease accounting rules

Lessee

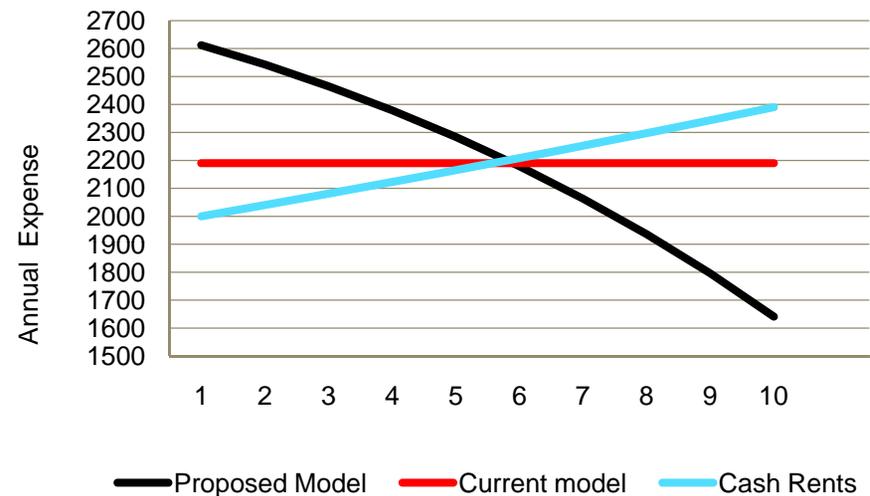
- Financial statements are not perceived to clearly depict the impact of operating leases since lease obligations are off balance sheet.
- Economically similar transactions can lead to significantly different accounting due to "bright lines," reducing transparency and comparability.
- Existing rules may provide opportunities to structure transactions to achieve a particular lease classification.
- Some users believe operating leases give rise to assets and liabilities that should be recognized in the financial statements of the lessee (assertion consistent with the 2005 SEC "off balance sheet" study and practice by many rating/agencies/analyst to impute leverage using a multiple of rent).
- The current accounting is believed to be conceptually flawed – for a simple lease, the definitions of both an asset and liability clearly are met.

Lessor

- The Boards are also proposing changes to lessor accounting to align with the new lessee accounting proposals. Some though question whether lessor accounting is "broken" and whether proposals are a sufficient improvement to justify the cost of making the change.

SUMMARY OF PROPOSALS IN THE LEASING ORIGINAL ED (AUGUST 2010)

- Operating lease accounting eliminated:
 - Balance sheet grossed up with an asset and liability for all leases
 - P&L – interest and amortization replaces lease expense; expense recognition front-loaded and more volatile
- Requirement to reassess estimates of the lease term and contingent cash flows
- Hybrid approach for lessor accounting – assessment of whether lessor retains exposure to risks and benefits associated with underlying asset



Lessee Accounting
The chart above depicts the impact on earnings for a basic 10-year lease with an initial annual rent of \$2,000, a 2% annual escalation rate and an assumed incremental borrowing rate of 7%.

SUMMARY OF PROPOSALS IN THE LEASING ORIGINAL ED (AUGUST 2010)

Continued

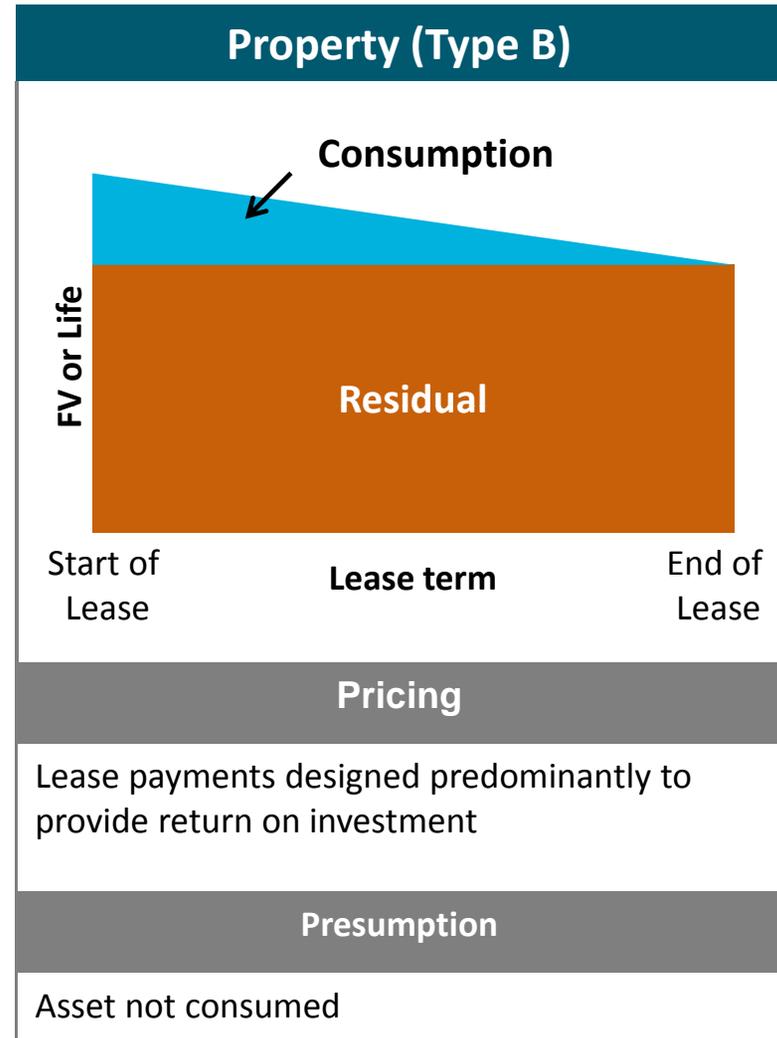
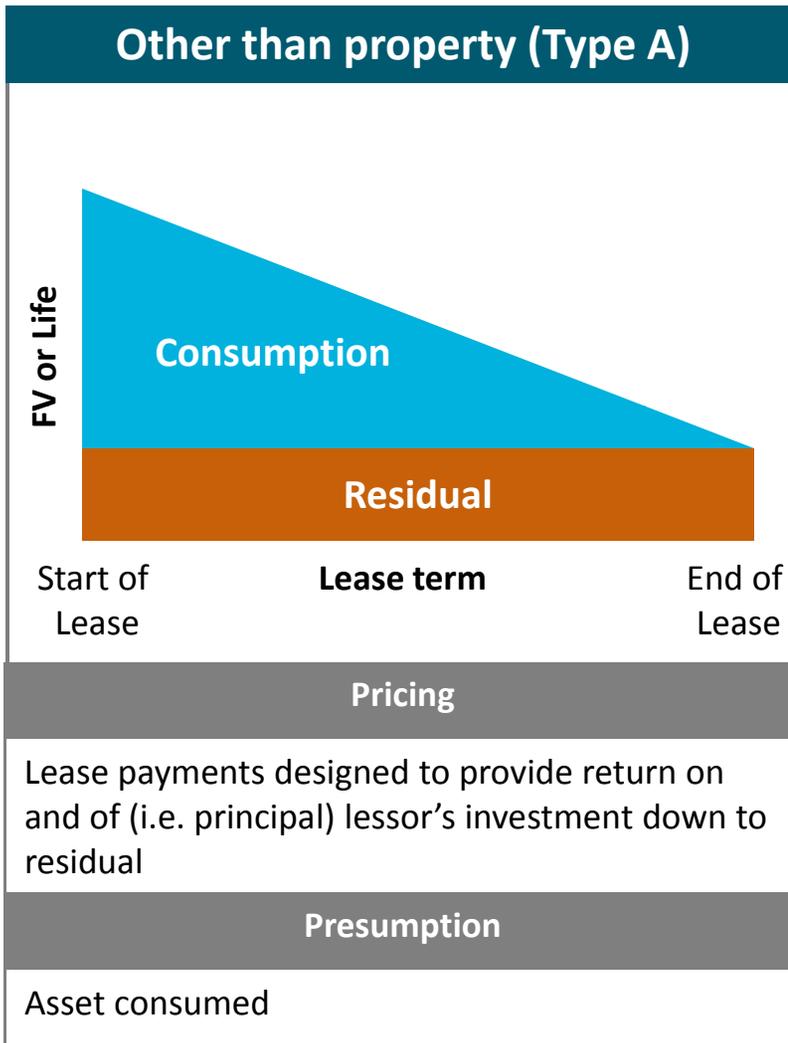
- Lease term, contingent rents, residual value guarantees estimated and re-measured
- Existing leases are not “grandfathered”
- Leases of tangible assets, short term leases and embedded leases scoped in
- Leases of intangible assets, purchase/sale transactions, immaterial items, investment property accounted for at FV scoped out

Balance sheet	
Assets	▲
Liabilities	▲
Income statement	
Rent expense	▼
Amortization	▲
Interest expense	▲
EBIT	▲
EBITDA	▲
EBITDAR	▬
EPS	▲▼
Cash flow statement	
Cash from ops	▲
Cash from finance	▼

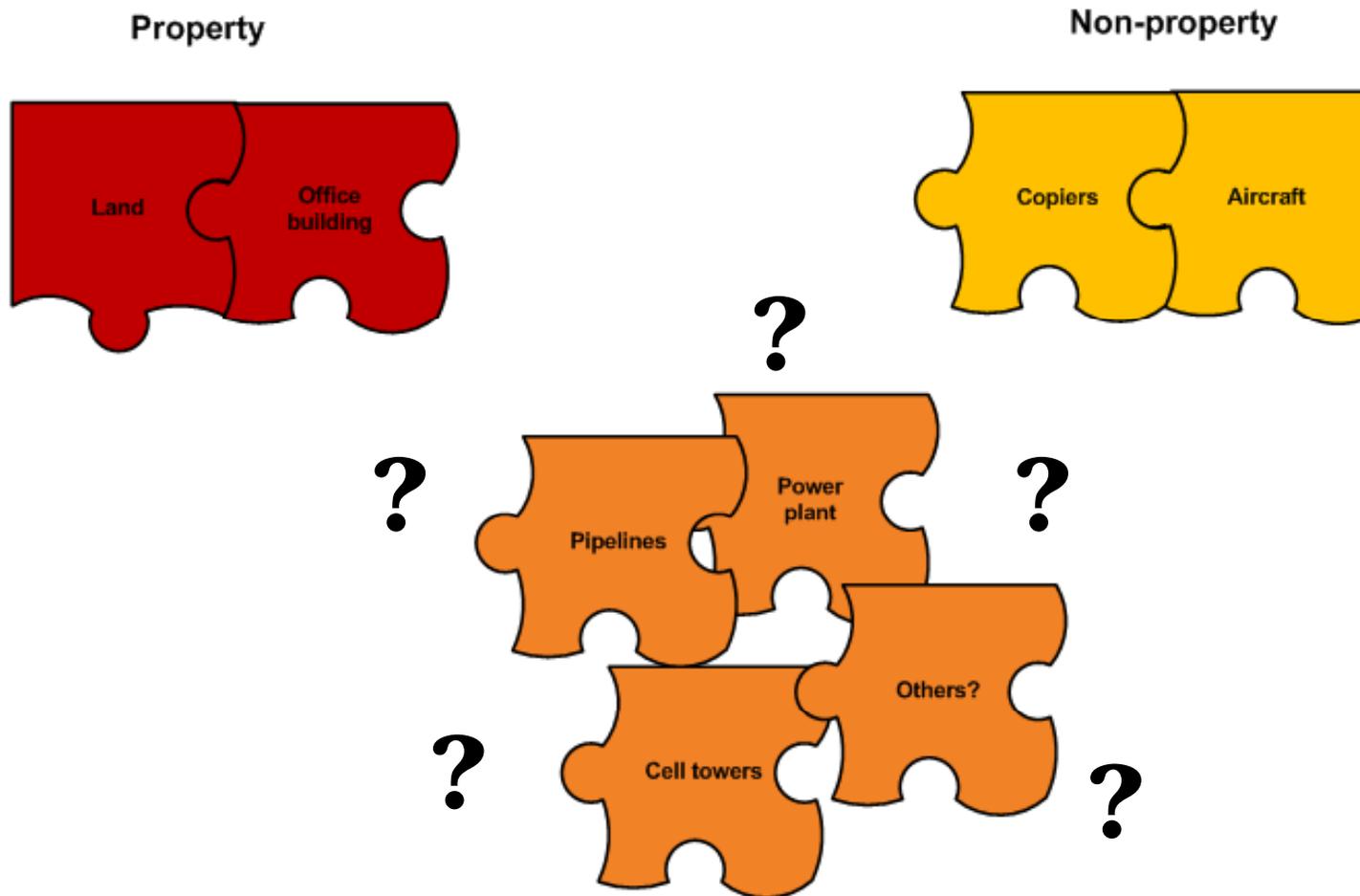
SUMMARY OF KEY CHANGES... FROM THE STARTING POINT

	 Current Model	 2013 ED
Definition of a lease / embedded lease	<ul style="list-style-type: none"> • Many embedded leases are off balance sheet operating leases 	<ul style="list-style-type: none"> • On balance sheet treatment for embedded leases
Lessee accounting	<ul style="list-style-type: none"> • Operating lease • Capital lease 	<ul style="list-style-type: none"> • All leases on balance sheet (except short-term leases) • Income statement: <ul style="list-style-type: none"> - Straight line approach (Type B) - Financing approach (Type A)
Lessor accounting	<ul style="list-style-type: none"> • Operating lease • Direct financing lease or Sales-type lease • Leveraged leases 	<ul style="list-style-type: none"> • Operating leases approach (Type B) • Receivable and residual approach (Type A) • No more leveraged leases accounting
Lease term	<ul style="list-style-type: none"> • Include renewal options that are "reasonably assured" of being exercised 	<ul style="list-style-type: none"> • Include renewal options where lessee has "a significant economic incentive" to exercise
Variable lease payments	<ul style="list-style-type: none"> • Contingent rentals are generally expensed as incurred • Rents based on index/rate and in-substance fixed are included • Remeasurement not required 	<ul style="list-style-type: none"> • Usage or performance-based rents are not included • Rents based on index/rate and in-substance fixed are included • Remeasurement required

CONSUMPTION BASED PRINCIPLE

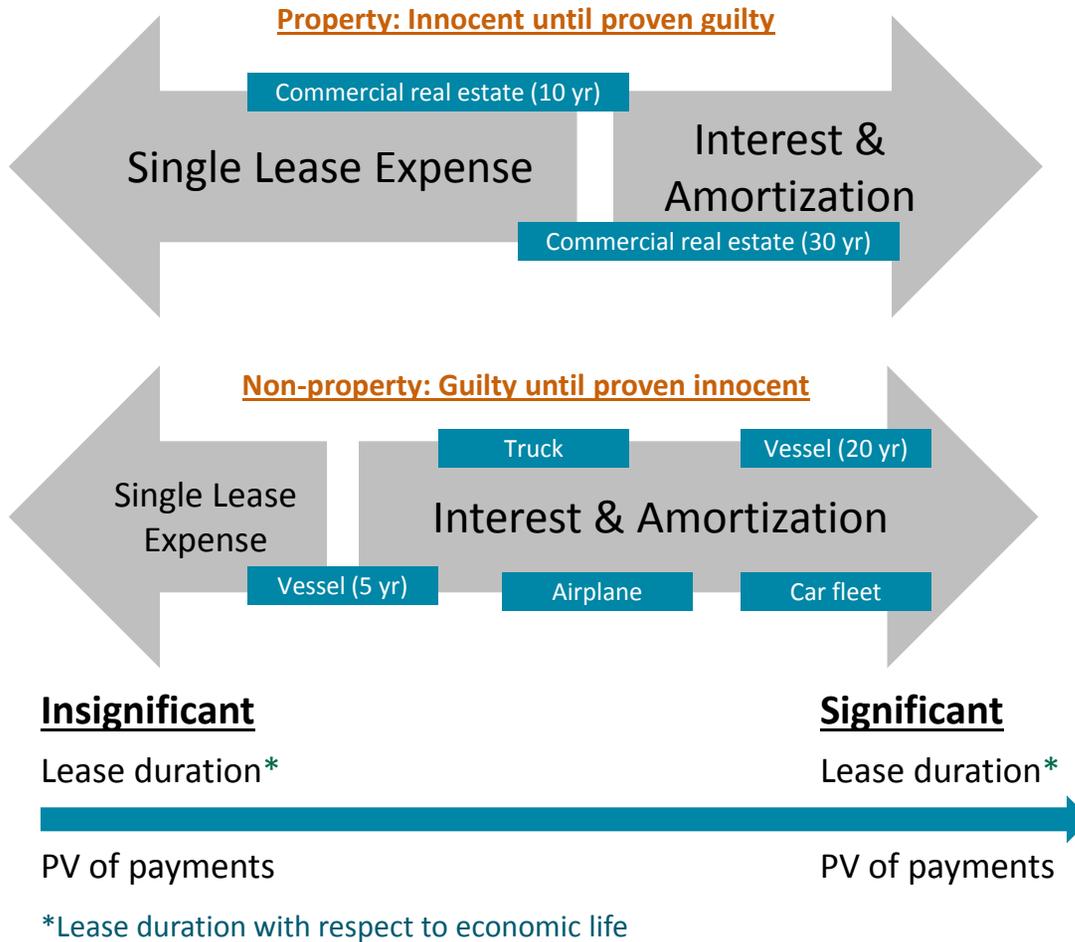


THE GREAT DIVIDE



DUAL MODEL

The new dividing line – *Lessee* accounting



Rebut the presumption of insignificant consumption if:

Lease term **major part** of economic life of the underlying asset

OR

PV of fixed lease payments are **substantially all** FV of underlying asset

Rebut the presumption of more than insignificant consumption if:

Lease term **an insignificant portion** of economic life of the underlying asset

OR

PV of fixed lease payments are **insignificant** relative to the FV of underlying asset

LESSEE ACCOUNTING

	Balance Sheet	Income Statement	Cash Flows
Financing (Type A)	Right-Of-Use (ROU) asset ⁽¹⁾	Amortization expense Interest expense	Principal = Financing Interest = Operating ⁽³⁾ Variable = Operating
Straight-line / Short-term (Type B)	Lease liability ⁽²⁾	Lease expense	Operating

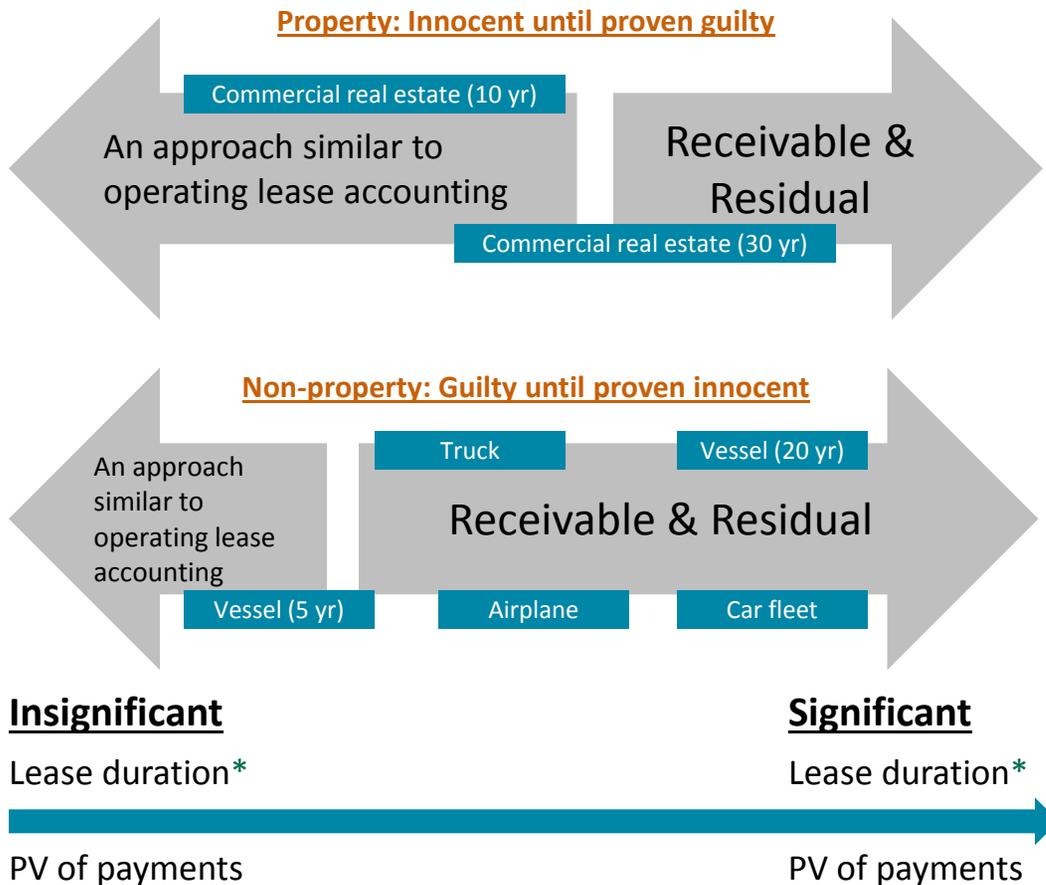
(1) Initially measured at same amount of liability plus initial direct costs

(2) Measured at present value of lease payments; subsequently measured at amortized cost using effective interest method

(3) Presentation may be different under IFRS

DUAL MODEL

The new dividing line – *Lessor accounting*



*Lease duration with respect to economic life

Rebut the presumption of insignificant consumption if:

Lease term **major part** of economic life of the underlying asset

OR

PV of fixed lease payments are **substantially all** FV of underlying asset

Rebut the presumption of more than insignificant consumption if:

Lease term **an insignificant portion** of economic life of the underlying asset

OR

PV of fixed lease payments are **insignificant** relative to the FV of underlying asset

LESSOR ACCOUNTING

	Balance Sheet	Income Statement	Cash Flows
Receivable and residual (Type A)	Derecognize part of underlying asset and record: Lease receivable ⁽¹⁾ Residual asset ⁽²⁾	Profit on asset derecognized ⁽³⁾ Interest income on receivable and residual ⁽⁴⁾	Operating
Straight line (Type B)	Underlying asset remains on balance sheet	Lease income – straight line over term of lease	Operating

(1) Present value of lease payments plus initial direct costs

(2) Measured at an allocation of carrying amount of leased asset

(3) Profit allocated to receivable and residual on relative fair value basis. Profit on receivable is recognized on day one; any profit on the residual asset is not recognized until asset sold or re-leased at end of lease term

(4) Interest on residual based on estimated residual value

LEASE TERM

Lease Extension Options

- Included when the lessee has a “significant economic incentive” to exercise an option to extend (or not to terminate) the lease

Indicators

- Likely to be similar to those considered today
- Substantive bargain renewal options or economic penalties for non-renewal

Application Questions

- Likely on how “significant economic incentive” differs from the existing “reasonably assured” guidance:
 - How will non-contractual factors be considered (e.g. market priced renewals for mission critical assets)?
 - Would management’s intent and past business practice affect the evaluation?

VARIABLE LEASE PAYMENTS

INCLUDE

(in measurement of the lease obligations and assets)

Contingencies that are based on a rate or an index;

Any contingency that is an in substance (or “disguised”) fixed lease payment;

Any portion of residual value guarantees that are expected to be paid*; and

“Term option penalties” when consistent with renewal option assumptions

EXCLUDE

(unless in-substance fixed lease payments)

Variable lease payments that are usage-based (e.g. number of miles drive) or performance-based (e.g. based on tenant sales)

**For lessors, payments structured as residual value guarantee (RVG) should be included in the lease receivable at the commencement date.*

Note: Remeasure if facts or circumstances indicate a significant change.

REMEASUREMENT CONSIDERATIONS

Has there been a change in circumstances affecting whether the contract is, or contains, a lease?

Do lease payments depend on an index or rate?



Have there been significant changes in relevant factors?

Is there a significant modification to the contractual terms?

Is there a significant economic incentive to exercise any options to extend or terminate the lease?

TRANSITION

Full Retrospective	Modified Retrospective	
	Existing Capital/Finance Leases	All others
Apply new rules at commencement for each lease	<ul style="list-style-type: none"> No adjustment to existing assets and liabilities at transition date Specific guidance on the subsequent measurement of those assets and liabilities will be provided within the standard 	<p><u>Lessees</u></p> <ul style="list-style-type: none"> Lease liability at transition based on remaining payments. Use IBR at effective date (portfolio basis) RoU asset at transition based on proportion of lease liability at commencement, calculated on the basis of remaining lease payments <p><u>Lessors</u></p> <ul style="list-style-type: none"> Lease receivable at transition based on remaining lease payments Derecognize underlying asset Recognize residual at transition based on R&R approach
<ul style="list-style-type: none"> Hindsight allowed No requirement to estimate IDCs 		<ul style="list-style-type: none"> Leveraged leases eliminated Prepaid and accrued rent adjusts RoU asset



**WHAT CAN BE DONE NOW
IN ANTICIPATION OF
THE PROPOSED CHANGES?**

WHAT SHOULD COMPANIES BE DOING NOW?



- Spreadsheets likely inadequate.
- No longer simple footnote support and rent payments.
- Centralization of lease management?
- Clear lines for new leases versus extensions.
- Tracking on non-lease related items such as “Significant Economic Incentive” evaluation and related adjustments.

WHAT SHOULD COMPANIES BE DOING NOW?



- Tracking of critical data elements in a form required for the new standard.
- Recording of key data available for “calculations.”
- Support for “commencement dates.”
- Exclusion of executory costs.
- Inclusion of initial direct costs.

HOW READY ARE YOU?

“What data will I need and where will it come from?”

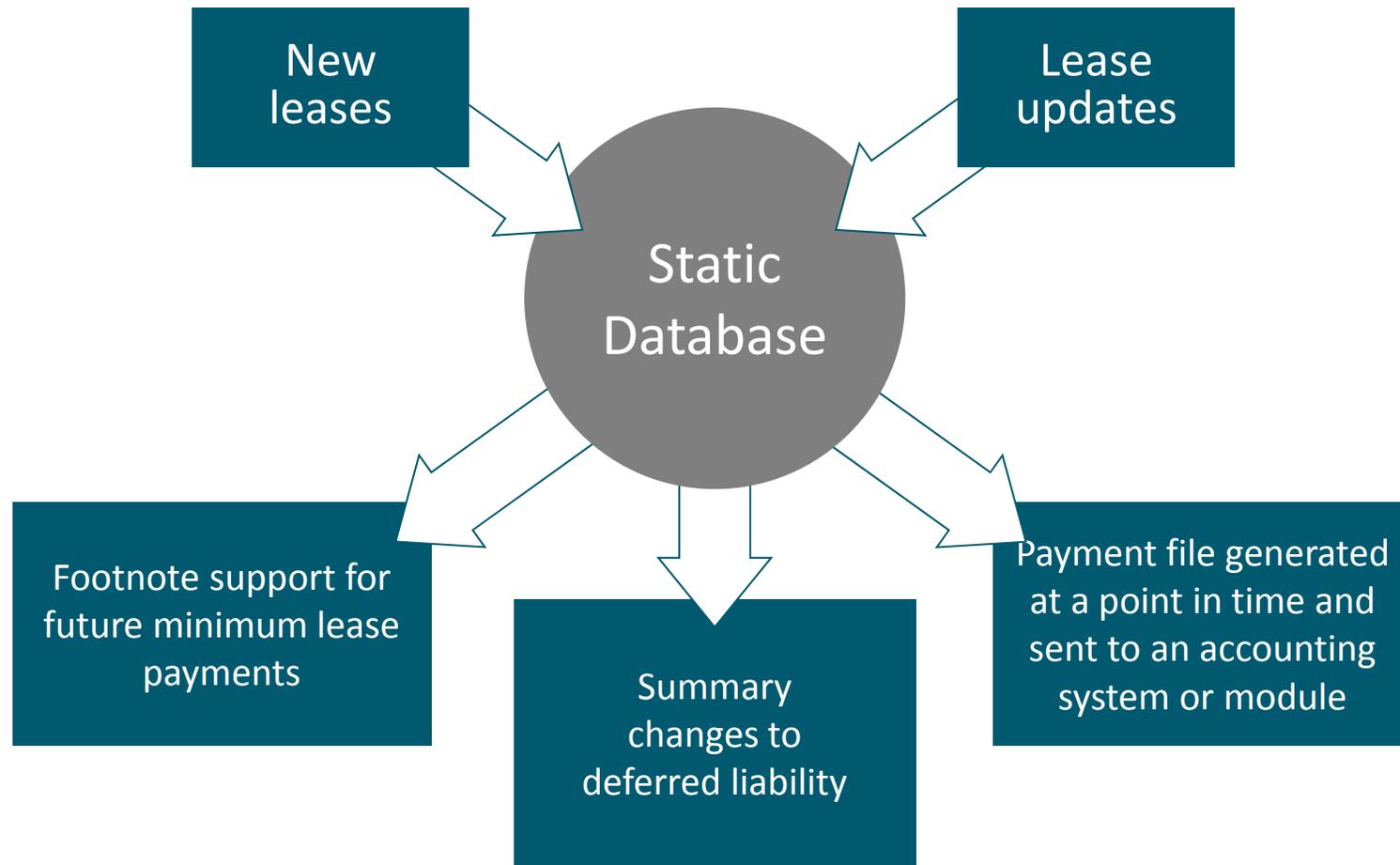
Data Points / Source	Lease	Market Forces	Government Statistics	Company/ Lessee	Market Representative/ Broker	Landlord
Key Lease Terms (contractual rent)	■					
All Future Options	■					
Past Option Dates & Decisions	■			■		
Renewal Option Pricing		■	■		■	■
Cost of Exercising Options	■					■
Early Termination Penalties	■				■	■
Restoration Costs	■			■		■
Internal Borrowing Rate			■	■		
Market Rental Rates		■	■		■	
Landlord - Tenant Improvements	■			■		■
Tenant - Tenant Improvements				■		
Prior / Future Rent Free Periods	■			■		
Re-evaluation Process		■		■	■	
Vacant Provision Costs				■		
Exchange Rates		■	■	■		

WHAT SHOULD COMPANIES BE DOING NOW?

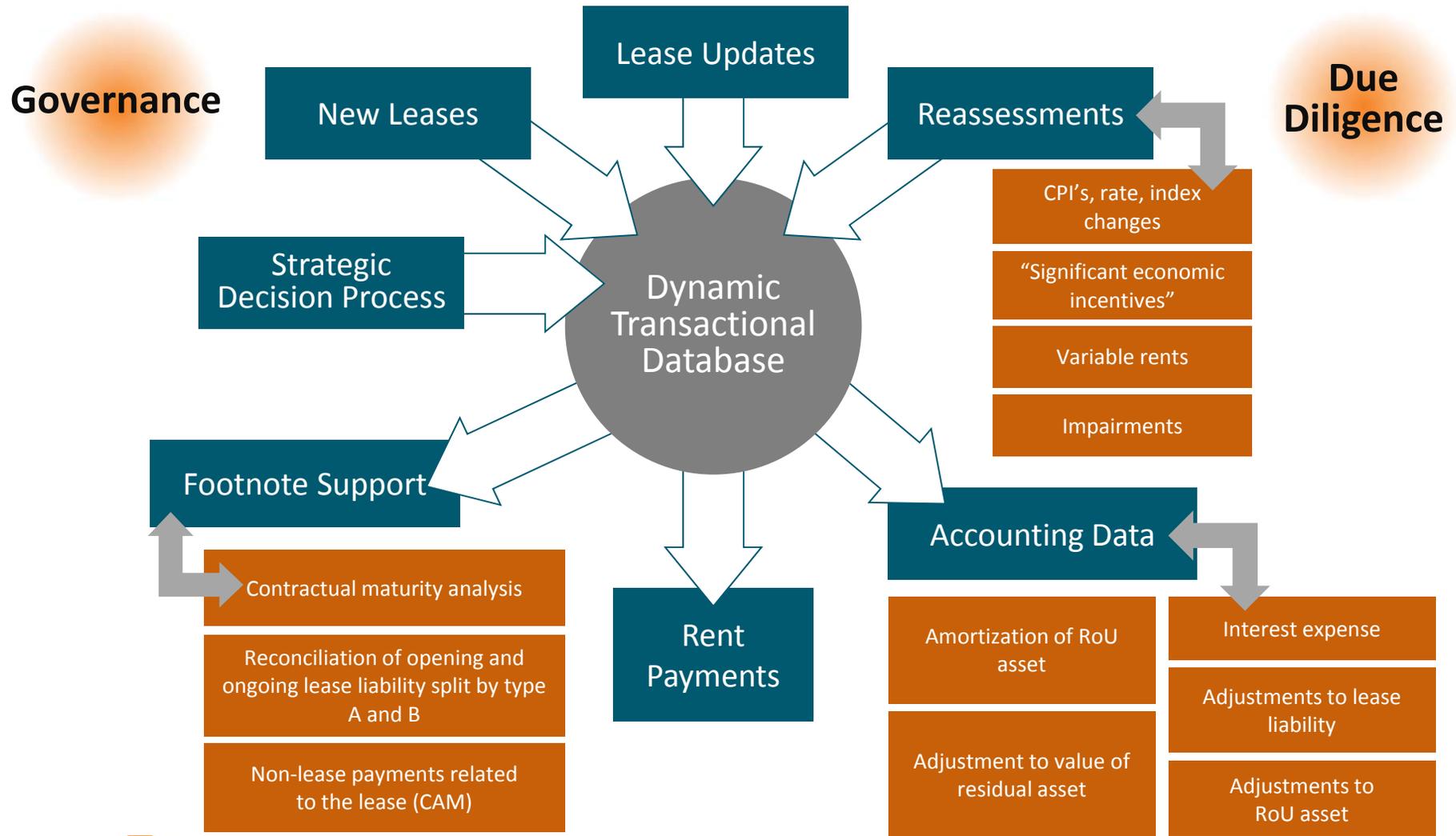


- Are current systems capable of new requirements?
- Monitoring software vendors to ensure timely implementation of new requirements.
- Integration of lease administration tools with the accounting system.
- Adequacy of controls to mitigate risk of incomplete or inaccurate lease accounting calculations.
- Progression toward a fully functional system.

TODAY'S TYPICAL STAND-ALONE LEASE ADMINISTRATION SYSTEM FUNCTIONALITY



LEASE ADMINISTRATION SYSTEM FUNCTIONALITY REQUIRED FOR THE NEW LEASE ACCOUNTING STANDARD



WHAT SHOULD COMPANIES BE DOING NOW?



- Monitoring of estimated impact on financials.
- Are all leases available globally for audit?
- Are they in English or translated to primary language?
- Documentation of “reassessments” at the reporting dates.
- Audit support through the administrative systems.
- New collaboration model likely to evolve from the new rules.



**STRATEGIC IMPLICATIONS
OF THE PROPOSED CHANGES**



LEASE ACCOUNTING

Strategic Considerations

Lease versus Own

- Will the new standard provide any additional incentive for occupiers to own vs. lease?

Sale Leaseback Transactions

- Will the new standard have a measurable impact on transaction volume?
- Is the immediate recognition of gain good or bad from an occupier perspective?

Credit Ratings and Debt Covenants

- Will corporate credit ratings be negatively impacted?
- Will banks try to extract a pound of flesh to recast debt covenants?

LEASE ACCOUNTING

Strategic Considerations

Real Estate Transaction Approvals

- Will corporation's finance departments play an increasing role in approving real estate transactions?
- Will it take longer to get real estate transactions approved?

Portfolio Rightsizing/Workplace Strategy

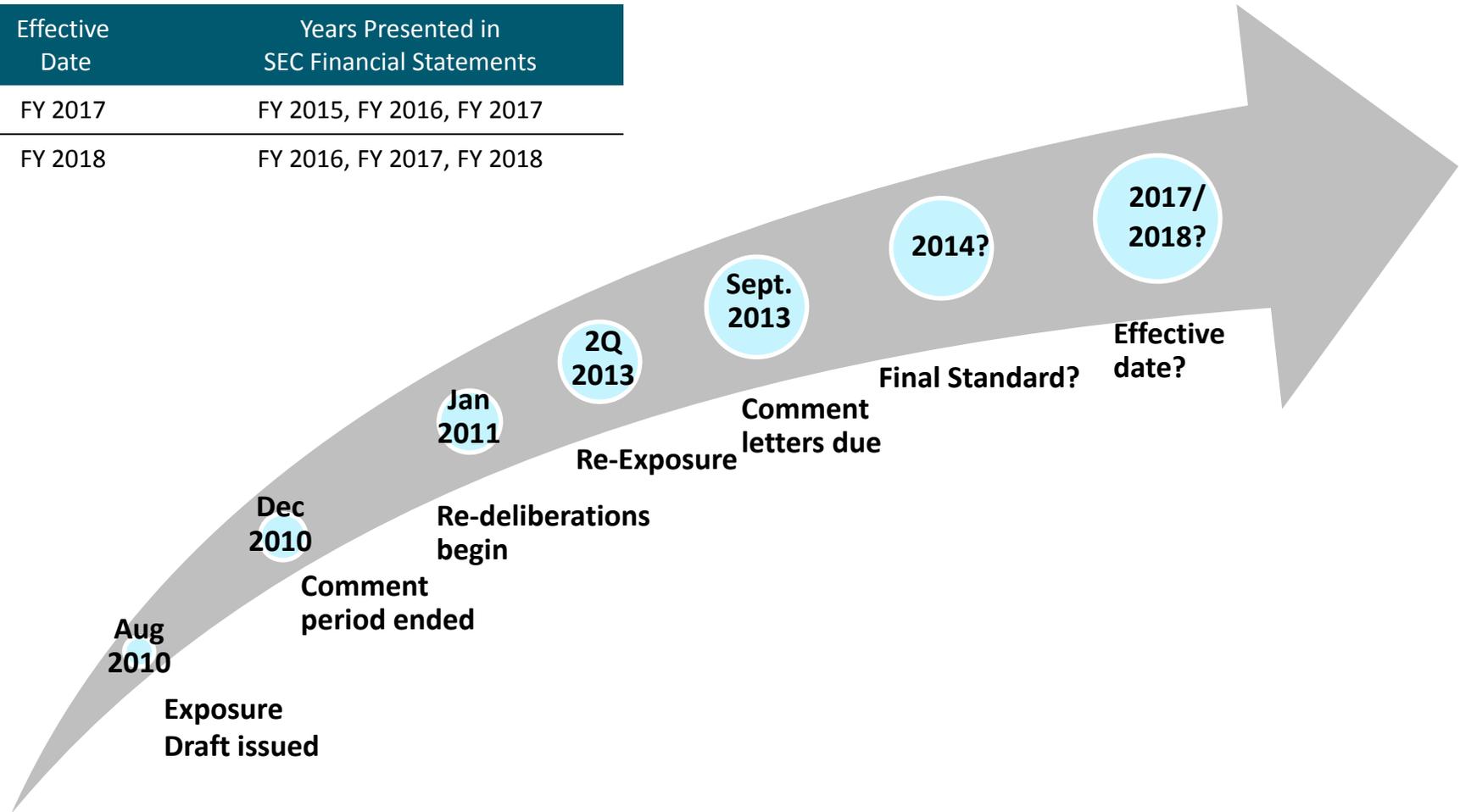
- Will the new standard increase the pace of corporate rightsizing?



**TIMELINE:
WHERE DO WE GO FROM HERE?**

LEASE PROJECT: TIMELINE

Effective Date	Years Presented in SEC Financial Statements
FY 2017	FY 2015, FY 2016, FY 2017
FY 2018	FY 2016, FY 2017, FY 2018



ADDITIONAL RESOURCES

For additional material and resources on this topic please go to:

- [CBRE's Lease Accounting Website](#)
- [PwC's Lease Accounting Website](#)

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THANK YOU

