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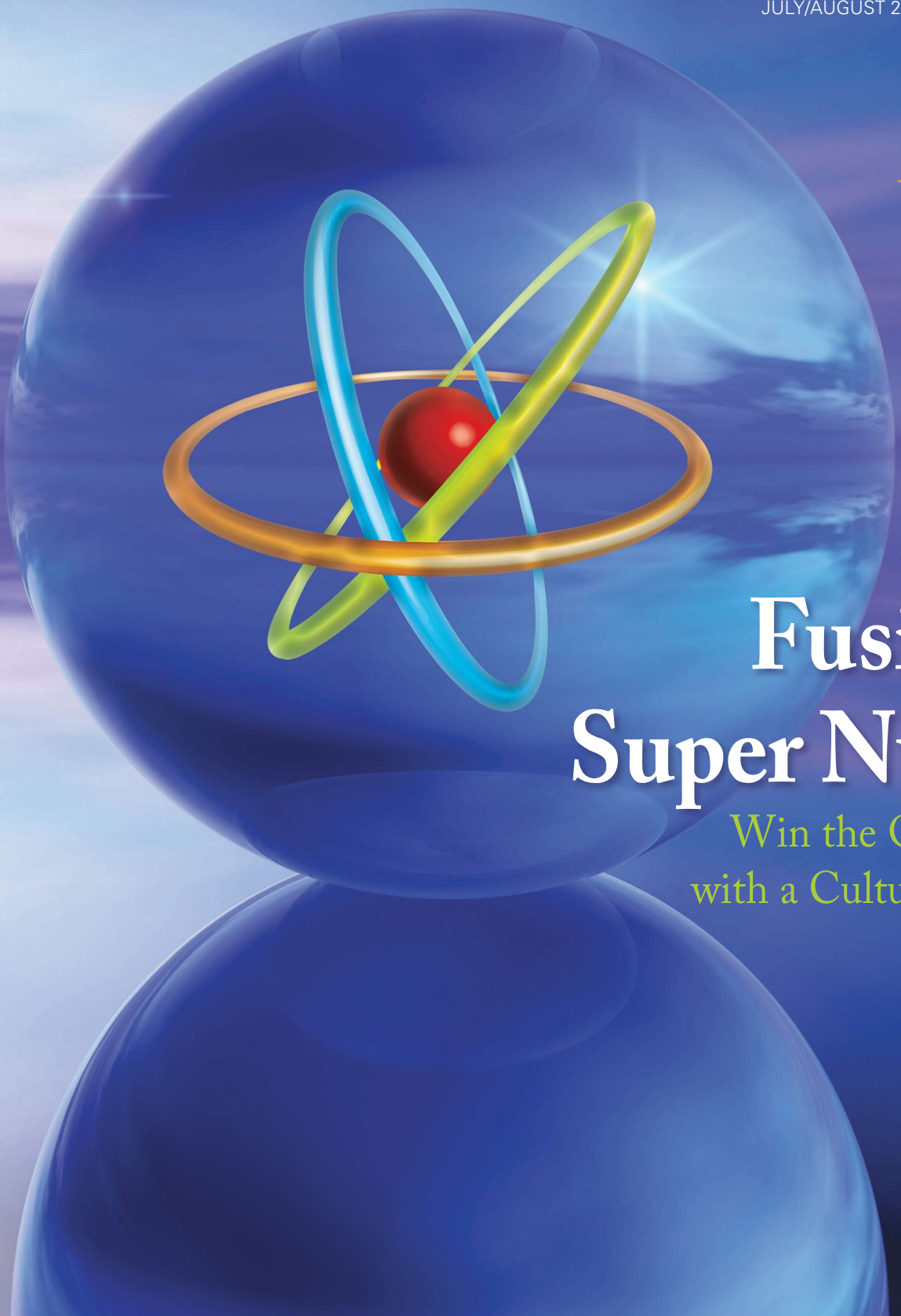

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Lease Accounting as a Catalyst to Change Corporate Real Estate Decision Making

BY TIM SCHELLE, SJUUL BALTUSSEN, LEON VAN LEERSUM AND RIANNE APPEL-MEULENBROEK

With new Lease Accounting regulation expected to come into full force in 2017, corporates will have to become more transparent about their lease obligations. Companies will be forced to have all real estate data up-to-date to meet the reporting requirements. Companies collecting detailed data will benefit from automatically being catapulted in the direction of strategizing their corporate real estate (CRE). Changing regulatory issues are not just compliance issues but can be a catalyst for corporates to change their CRE decision-making processes.

The existing accounting models for leases require lessees to classify their leases as either finance leases or operating leases. To date, a lessee is not required to recognize lease assets or liabilities for operating leases. Those models have been criticized for failing to meet the needs of users of financial statements because they do not always provide a faithful representation of leased assets. In particular, they omit important information about significant assets and liabilities arising from operating leases. As a result, many users of financial statements adjust the amounts presented in a corporate's statement of financial position to reflect the assets and liabilities arising from operating leases. **The International Accounting Standards Board (IASB)** and the **Financial Accounting Standards Board (FASB)** considered all leases an important source of financing that should be presented as such on the corporate balance sheet, removing the current difference between finance leases (on-balance) and operating leases (off-balance). Leasing is a means of gaining access to assets, obtaining finance and reducing an entity's exposure to the risks of asset ownership. The prevalence of leasing, therefore, means that it is important that users of financial statements have a complete and understandable picture of an entity's leasing activities. The lease contract will be recognized both on the asset side as a **Right of Use (ROU)** asset and the **Present Value (PV)** of payments during the lease term will be recognized as a liability.

The change in accounting standards will automatically shift the way in which corporations communicate about their **corporate real estate management (CREM)**. Where information on CREM was often opaque and incidental, financial reporting will ensure that lease liabilities will appear more often and more prominently in the corporate financial statements Companies that had not previously structured their real estate information will now be able to recognize the amount of CRE they use, own and rent and motivate the decisions that have been made in the past. These proposed regulations will be mandatory for all companies accounting under **IFRS/US GAAP**.

Decision Making

CRE Strategies are formed within an organizational and environmental context. Since the proposed lease accounting affects the environmental context by changing the legal environment, CRE strategies could indirectly be affected by new regulatory issues towards leasing. In addition, strategies are implemented in order to ensure the corporations' continuity and to maximize shareholder value. To be able to do so, it is essential for CRE strategies to be fully aligned with the corporate business strategy. This alignment is classified according to the five stages of the Joroff model (illustrated in **figure 1** for AEX- listed companies).

The CREM contribution depends on the stage of CREM on the **Joroff** model and competitive advantage is only realized when CREM operates at the strategic level and therefore fully aligned with the overall corporate strategy. CRE departments

that operate below 'Strategist' level are in general driven by their added value in terms of profitability and productivity. These financial performance indicators are exposed to the new Lease Accounting regulations. If these performance indicators change significantly, it could result in adaption of the CRE strategy in order to meet the internal performance goals. For those CRE departments, new regulatory issues could form a bottleneck. Lease Accounting can therefore be a catalyst for revising CRE strategy and may result in its evolution on the Joroff model.

What about operating decisions? When CRE departments lack an explicit real estate strategy consistent with their business strategy, they may exercise operating decisions that are unrelated to (or even contradict) the corporate business strategy. This could force companies that rely heavily on financial components and have large real estate portfolios to make changes to their data management, transaction ma nagement and/or portfolio decisions, all with respect to CRE.

The Impact Quantified

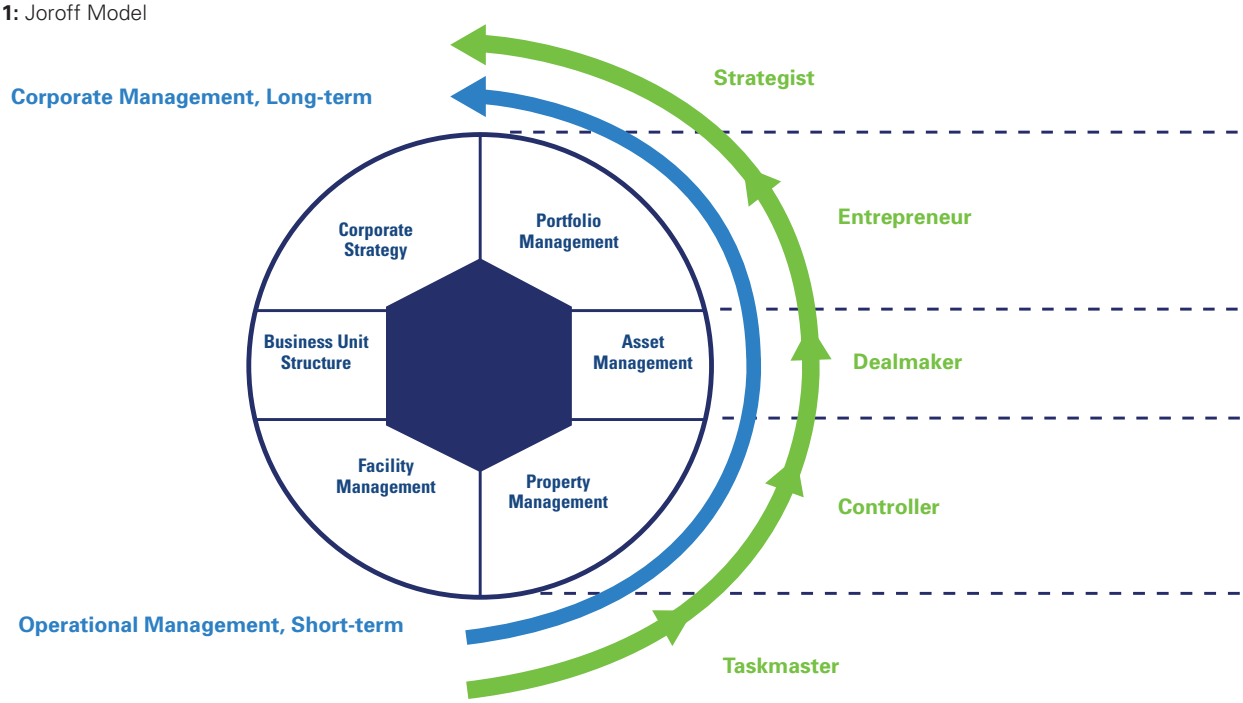
Schelle & Baltussen have scrutinized CRE strategies and operating decisions of the majority of listed companies in The Netherlands. To be able to quantify the impact for each corporate, an extensive analysis was conducted to determine what the relative impact of lease accounting will be on key performance indicators, balance sheets and income statements.

Prior to the actual analysis they observed that in contradiction to previous studies, the amount of real estate and land (seven percent) on the analyzed companies' balance sheets seemed to be much lower than expected. This might be caused by the method that is used for determining the value – book value versus market value. In addition, 74 percent of lease portfolios consist of operational leases. Irrespective of whether these leases are knowingly structured as operational leases or not, the IASB is right in stating that it is hard to justify that presenting just 26 percent of the total lease liabilities on the balance sheet is transparent.

The CRE-related impact seems to be significant, especially for corporations with a high retail lease exposure. Also, corporations with a large exposure towards leases related to aircrafts and freighters are subjected to the magnitude of lease accounting. However, the analysis illustrates that the greater part of the impact can be traced back to real estate leases.

Table 1 shows that lease accounting impacts key financial

Figure 1: Joroff Model



Source: Schnelle & Baltuggen (2013)

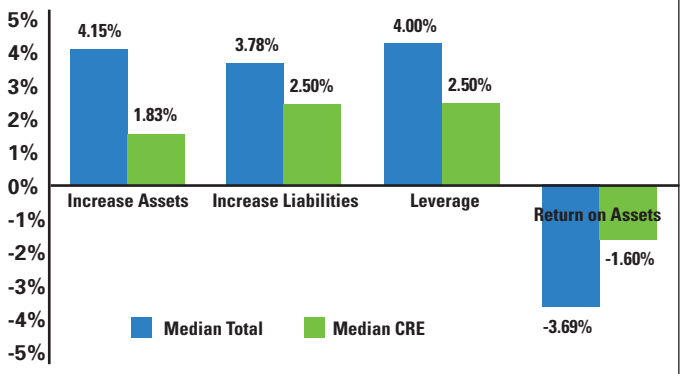
ratios. Since these ratios play an important part in the decision making of internal reviews, lenders, rating agencies and shareholders, corporations tend to mitigate the impact as much as possible. Especially corporations that endure more impact than comparable corporations within the industry could expect additional questions from stakeholders.

In general, the impact for a particular company would be largely based on (a combination of) three factors:

1. The maturity of its Corporate Real Estate Management (position within the Joroff model)

2. The size of a company's operating lease portfolio relative to its balance sheet, and

Table 1: Median Impact



Source: Schnelle & Baltuggen (2013)

3. A company's sensitivity, due to their CRE strategy, to the presentation of their financial statement

The Tools

One of the consequences of the implantation of lease accounting is the compliance issue with debt covenants, especially when, due to incomplete disclosures recorded in the past, additional information about the CRE portfolio becomes visible. Before renegotiating it is essential to predict what the impact will be and prepare to reduce the impact, if necessary. Since the greater part of the impact is related to real estate leases these are the ones that could most influence the impact. Therefore, it is quite likely that the 10 management variables **(figure 2)** will be used as instruments to mitigate the impact. For corporations with stressed financial positions, the management variables are a welcome tool for executives to reduce the impact of lease accounting.

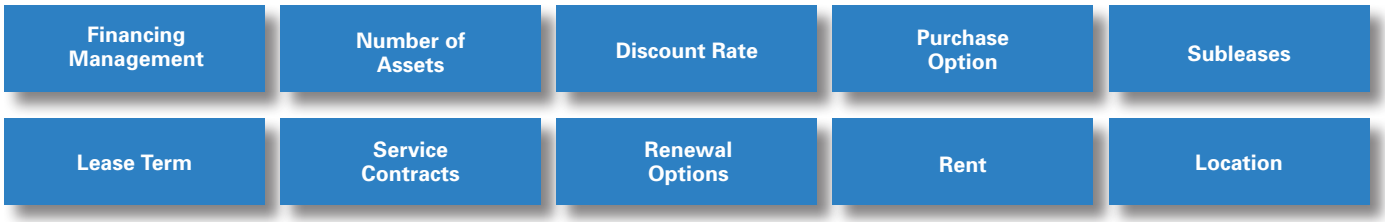
To what extent these 10 variables should be altered is a question that should be answered for every real estate transaction in the context of the real estate strategy. The fact is that all real estate transactions and renewals are subject to future reporting; as such, the proposed Lease Accounting is already 'in play'.

What is the Market Expecting?

During the interviews conducted by Schelle and Baltussen, an important observation was the idea that the proposed accounting guidance would require a new level of information because every lease, no matter the size or length, would need to be accounted for and scrutinized over its term. Several companies that have already begun the implementation process admit-

Figure 2: 10 Management Variables

Source: Schnelle & Baltuggen (2013)



ted to realizing that their current information systems lack the required detail. Therefore, managing an entire portfolio of complex leases, subleases and segmented reporting would prove to be extremely challenging. Some companies that already installed specific lease tracking systems were provided with a level of understanding far beyond that which had previously been available.

Assuming virtually every company with the need for this data would incorporate such systems, this will create clarity and possibly even efficiency throughout the industry, as companies become more aware of the space they occupy versus their actual space requirements. Consequentially, companies will be forced to look critically at their real estate strategies and the lease accounting changes may be a catalyst to implementing change.

A good understanding of the CRE portfolio is a critical ingredient for successful implementation of the corporate (real estate) strategy. It also ensures that CREM can communicate its contribution to the company in a language that the top decision makers understand. This 'language' will become far more important when the relationship between the CRE executive and the CFO changes due to the proposed lease accounting. As a result, new questions about CRE and its strategy will arise. CRE managers will have the potential to visibly contribute to the future (financial) performance of their organizations.

Starting Today

Changing regulatory issues are not just compliance issues for all organizations, but they can also be a catalyst for corporates to change their decision-making processes. These factors make companies more likely to change their behavior to mitigate the effects of the proposed changes. CRE will receive more attention from the financial world and therefore from the CFO.

The new accounting rules will probably be introduced on 1 January 2017. This means that firms using US GAAP should report comparative figures starting from January 1, 2015 (2016 for IFRS users). Moreover, all necessary information and transitions should be taken into consideration before this date. Every CRE department should view current decisions on (long-term) lease commitments in the light of these new regulations. This makes it necessary for a CRE department to collect the necessary data and analyze the impact on real estate decisions in the short term and start today.

Sources

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- International Accounting Standards Board (2013). www.ifrs.org

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