

## IFRS Lease Accounting impact on Corporate Real Estate Management

With new Lease Accounting regulation ahead and expected to come into full force in 2017, firms 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 management. 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) consider leases as an important source of financing and 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 mean of gaining access to assets, of obtaining finance, and of 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 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.

### The impact quantified

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 (figure 1).

CRE strategies and operating decisions of the majority of listed companies in The Netherlands have been scrutinized, using the Imhoff, Lipe, and Wright method<sup>1</sup>, to be able to quantify the impact for each corporation. It is implied that €5 billion, of the total of €6 billion of CRE value that will be recognized on-balance, has a significant potential to form a bottleneck for CREM divisions (figure 1).

Competitive advantage is only realized when CREM operates at the strategic level and, thus, depends on the stage of CREM on the Joroff-model. CRE departments that operate below 'Strategist' level are in general driven by their added value in terms of profitability and productivity. This could force firms that rely heavily on financial components and have large real estate portfolios to make changes to their data management, transaction management and/or portfolio decisions, all with respect to CRE.

The analysis shows that lease accounting impacts key financial 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.

---

<sup>1</sup> The work of Imhoff, Lipe, and Wright (1991) provides a widely used method to capitalize operating leases

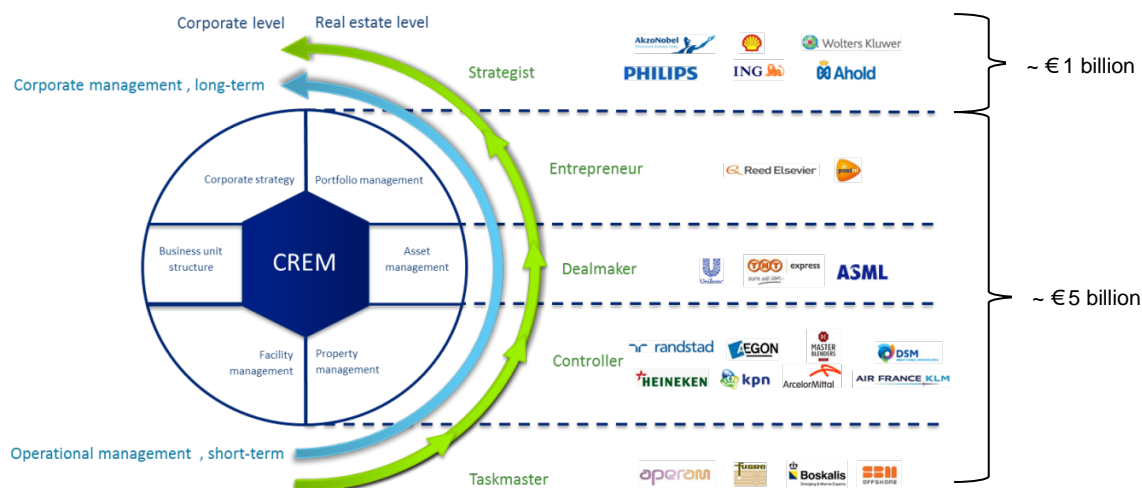


Figure 1: AEX listed corporations aligned on the Joroff-model

In general, the impact for an organization 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,
- 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 ten management variables (i.e.; financing arrangements, number of assets, discount rate, purchase option, subleases, lease term, service contracts, renewal options, rent, and location), will be used as instruments to mitigate the impact. For corporations with stressed financial positions, the management variables are a welcome tool to deal with the impact of Lease Accounting. To what extent the ten variables should be altered is a question that should be answered for every real estate transaction in the context of the CRE strategy. The fact is that all transactions and renewals are subject to future reporting and as such the proposed Lease Accounting is already 'in play'.

### What is the market expecting?

During the interviews conducted, 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 admitted 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 CRE 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 boardroom' changes due to the proposed lease accounting. As a result, new questions about CRE and its strategy will arise and CRE managers will have the potential to visibly contribute to the future (financial) performance of their organizations.