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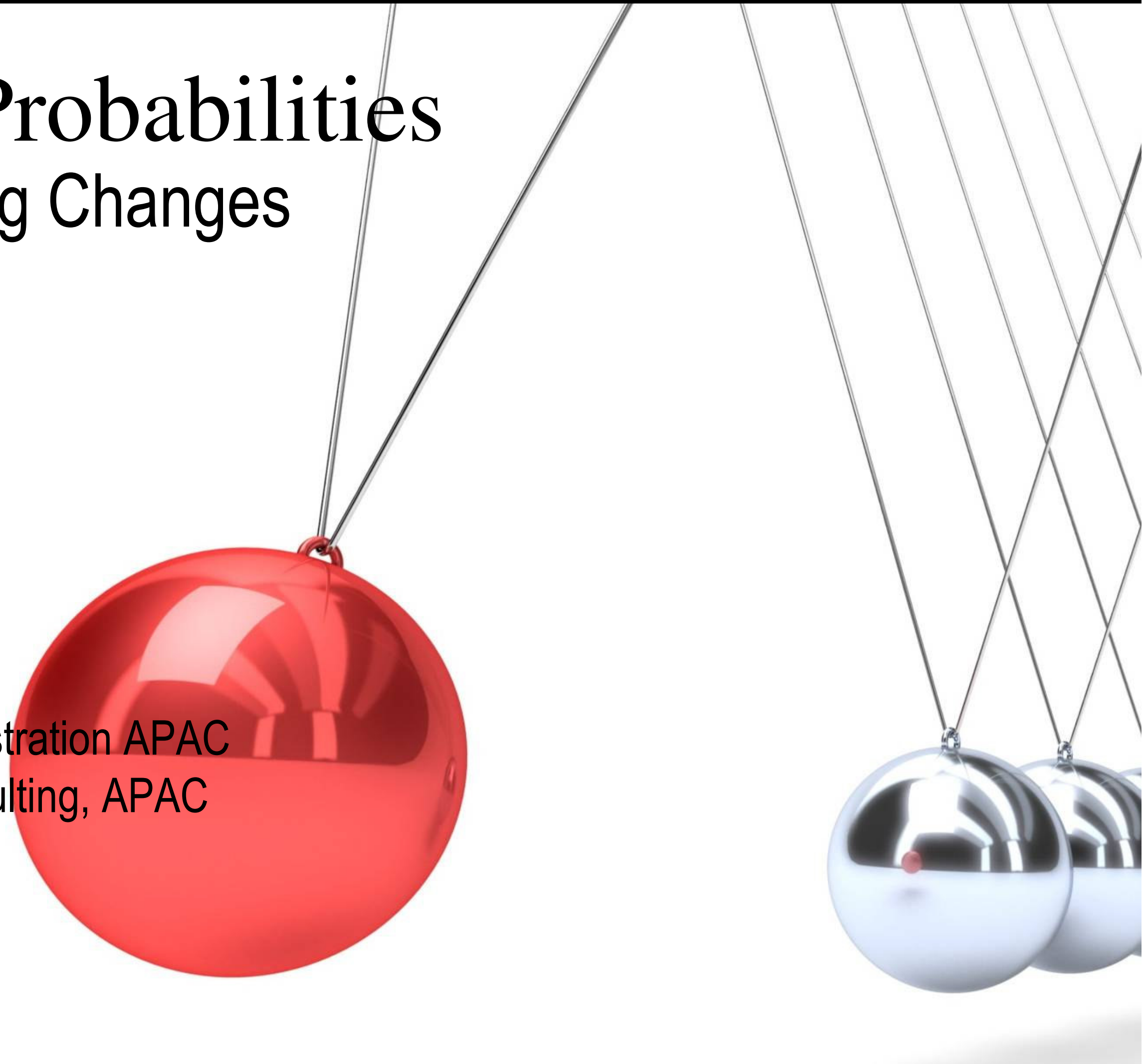
Real value in a changing world

The Balance of Probabilities
Global Lease Accounting Changes

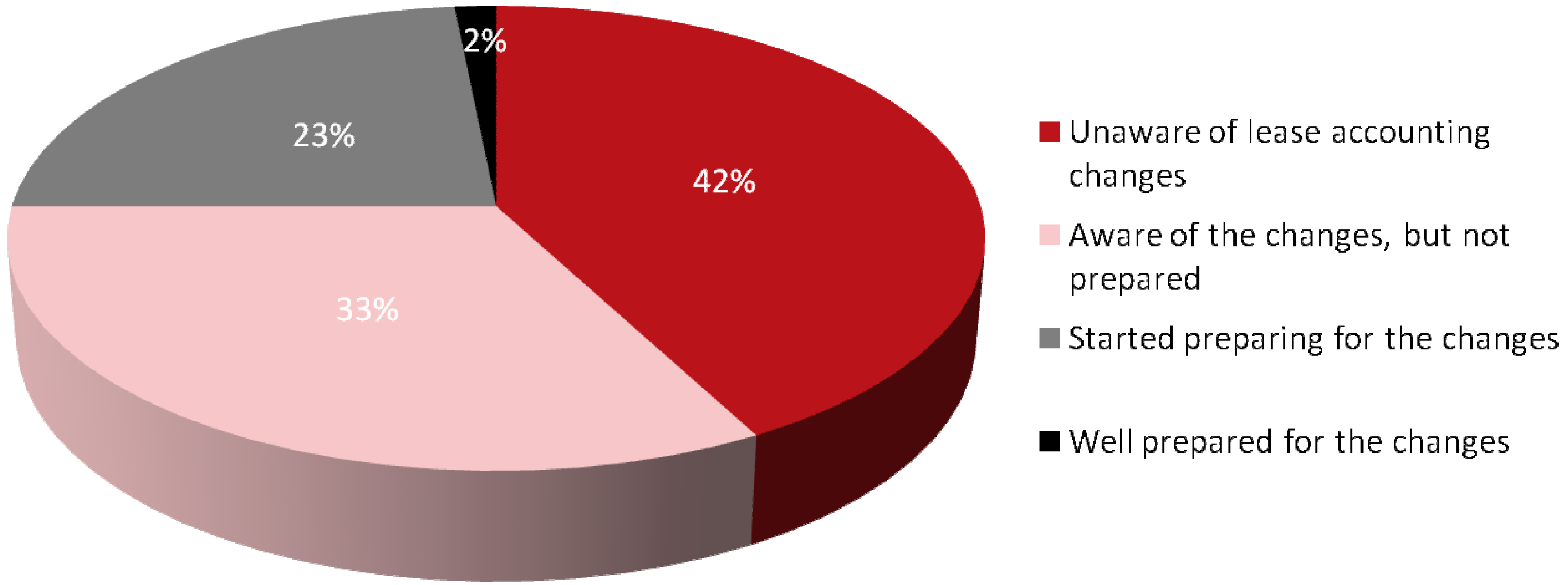


David Brown, Head of Lease Administration APAC
Sylvia Koh, Head of Corporate Consulting, APAC
November 2010

Are you ready for the impact?

- Balance sheets to swell by trillions of dollars globally
- Front-end hit to the P&L and on-going volatility
- Huge administrative burden
- Increased complexity of real estate decisions
- Finance/treasury influence on CRE decisions
- More stringent compliance and audit requirements

How prepared are you for the global lease accounting changes?

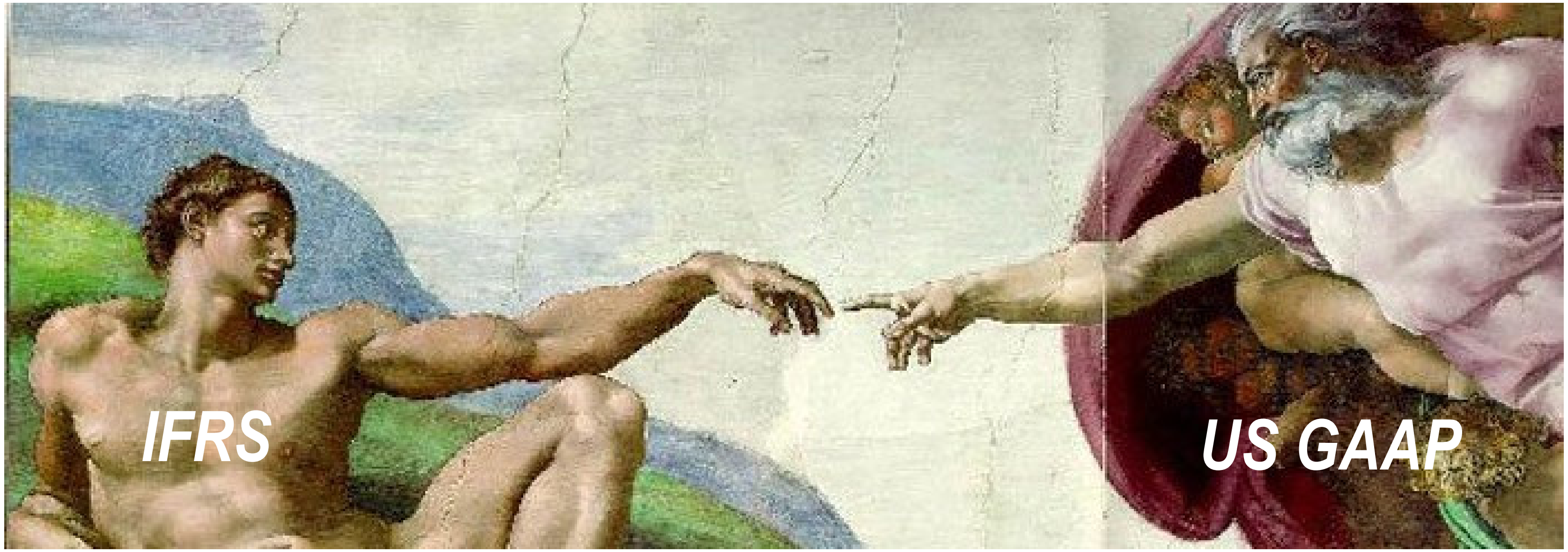


Agenda

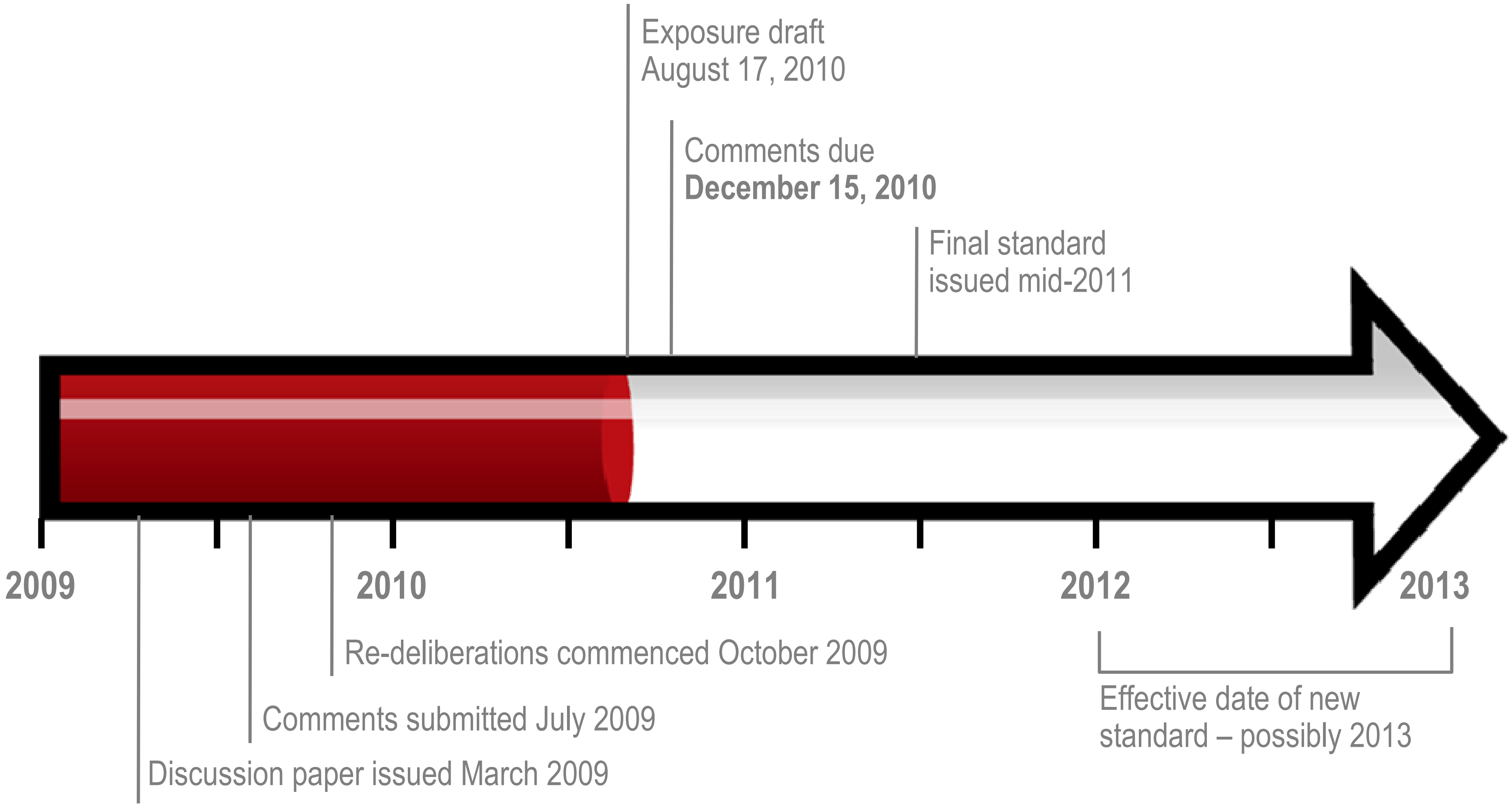
- Background
- Timeline
- Proposed Changes
- Preparation

Who owns the plane?

Convergence



Timeline of events



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What will be effected?

- Includes all leases – property, plant and equipment (PP&E)
- Effects lessees and lessors
- Not just what is written in the lease – intent and perceived fair value just as important
- No grandfathering or exclusions, except…
  - Leases intended for a term of less than 12 months
  - Ignore the impact of interest, use accrual accounting
  - Leases of intangibles (software, licenses, patents) and exploration equipment for non-regenerative resources currently excluded

What's changing?

Financial statement	Operating lease	Finance lease	Right-of-use model
Profit and loss	• Lease rental expense	• Amortization • Finance expense	• Amortization • Finance expense
Balance sheet	• Off balance sheet	• Leased asset • Finance lease liability	• Right-of-use asset • Obligation to pay rentals

Will become obsolete

What will the new expense look like?

Office Lease			
Rentable Sq. Ft.	100,000	Lease Term	6 yrs, 4-yr renewal option
Initial Rent	$14 NNN p.s.f.	Corporate Borrowing Rate	7%
Rent Increase	2% per year	NPV of Rents	$10,941,733

20% higher year 1 rent!

Year	Cash Rent	Current P&L Rent Expense	Right of Use Expense	Current Rent Expense - ROU Difference
1	$ 1,400,000	$ 1,532,961	$ 1,835,277	$ 302,316
2	$ 1,428,000	$ 1,532,961	$ 1,778,644	$ 245,683
3	$ 1,456,560	$ 1,532,961	$ 1,717,917	$ 184,956
4	$ 1,485,691	$ 1,532,961	$ 1,652,801	$ 119,840
5	$ 1,515,405	$ 1,532,961	$ 1,582,977	$ 50,016
6	$ 1,545,713	$ 1,532,961	$ 1,508,105	$ (24,856)
7	$ 1,576,627	$ 1,532,961	$ 1,427,821	$ (105,140)
8	$ 1,608,160	$ 1,532,961	$ 1,341,733	$ (191,228)
9	$ 1,640,323	$ 1,532,961	$ 1,249,422	$ (283,539)
10	$ 1,673,130	$ 1,532,961	$ 1,150,438	$ (382,523)
Total	**$ 15,329,609**	**$ 15,329,609**	**$ 15,245,136**	

Amortization + finance charge

P&L treatment

Balance sheet treatment

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10	$	1,673,130
Total	**$**	**15,329,609**

Discount cash rent by 7%

- Determination of lease term that is "more likely than not to occur"
- Projection of cash rent beyond current term
- Projection of other applicable non-rent expenses over applicable lease term

What will the new balance sheet look like?

	Year 0 – Current $m	Year 0 – New $m
Current Assets	16,000	16,000
Non-current Assets	18,000	18,000
Lease assets	—	10,942
Total assets		
Current Liabilit		
Current lease liability	—	(1,400)
Non-current liabilities	(4,000)	(4,000)
Non-current Lease liability	—	(9,542)
Total liabilities	(16,000)	(26,942)
Shareholders Equity	18,000	18,000

Amortized evenly over lease term

finance charge

Assets

- PV of lease payments over lease term "more likely than not to occur"

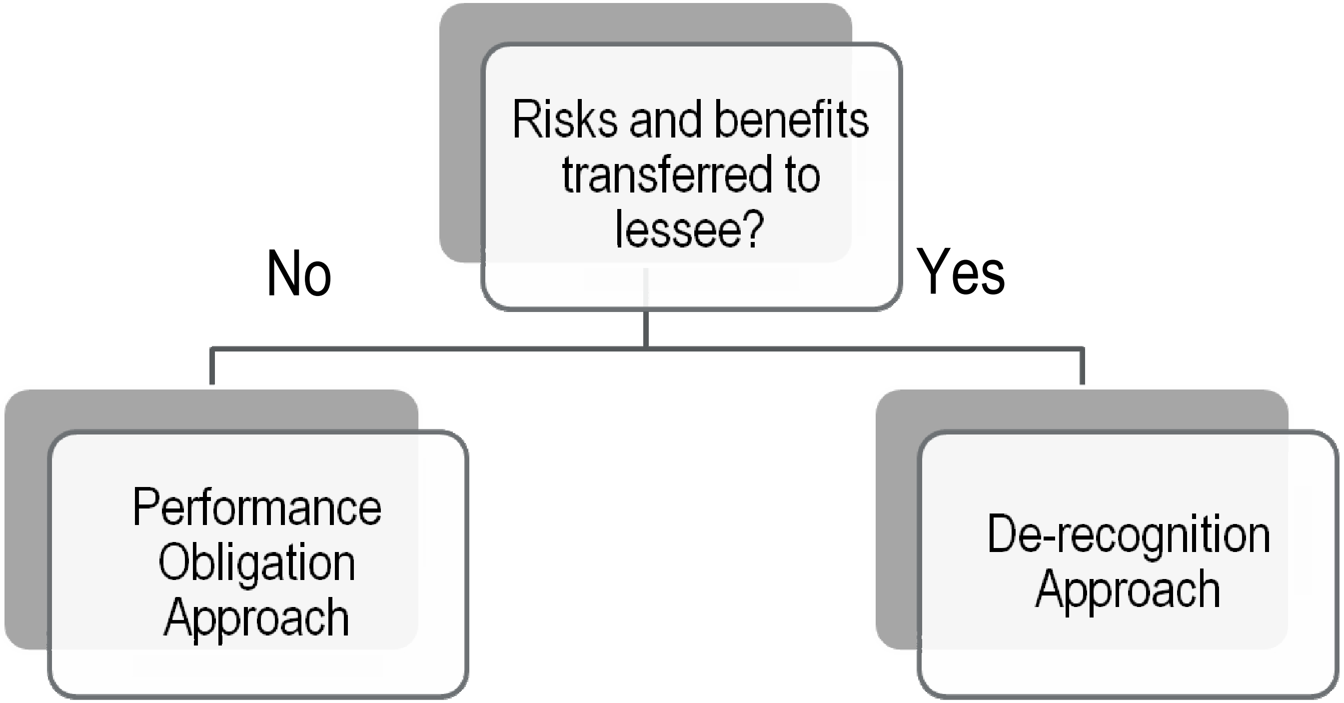
Liabilities

- Liability to make lease payments
- Accrued finance charges

Periodic re-assessment required

	Existing leases	Proposed leases
Liabilities /Equity	.89	1.5
Debt/Equity	.22	.75
Liabilities /NCA	.89	1.5
Current ratio	1.3	1.19

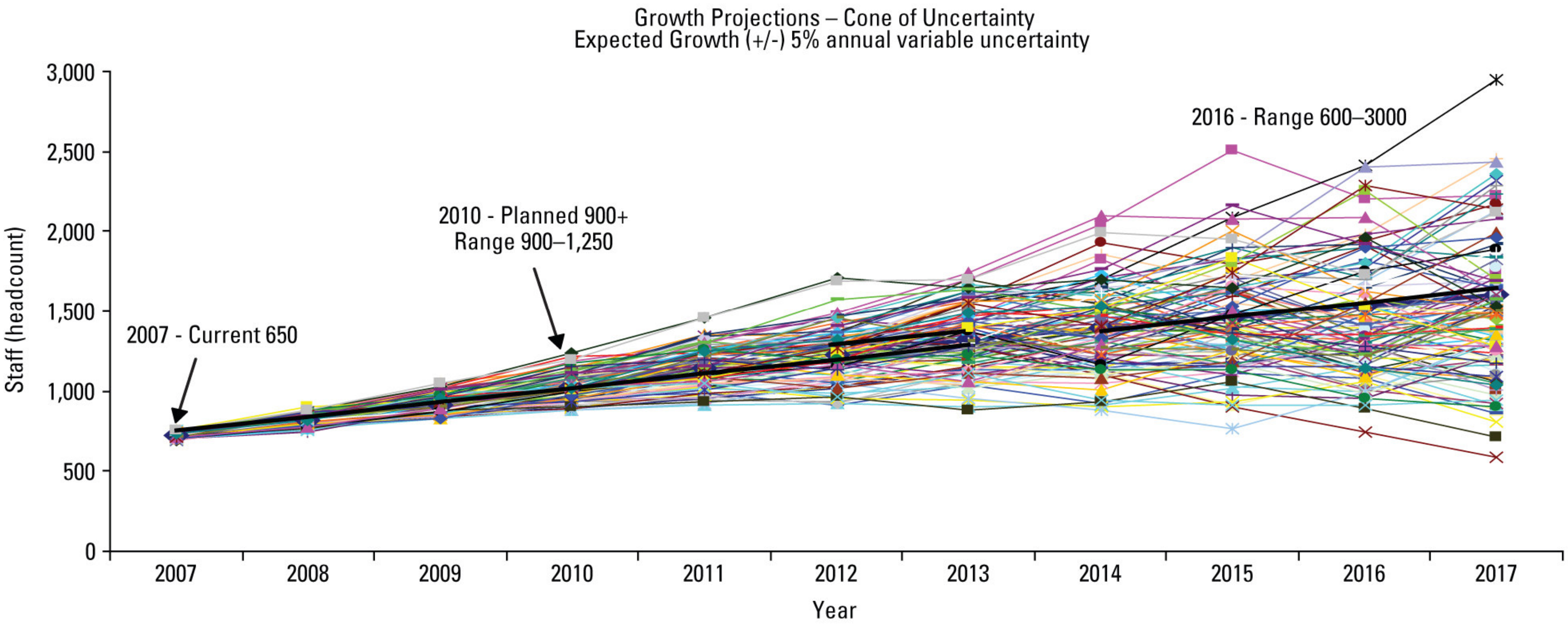
Lessor treatment



- Asset remains on the balance sheet
- “Right to Receive Lease Payments” asset recorded
- Performance obligation recorded to arrive at Net Lease Asset
- Income recorded over the life of the lease

- Value of part or all of the asset transferred to lessee is “derecognized” in the balance sheet
- May result in a profit or loss on P&L
- Rent receivable reflected
- Interest income recognized

The difficulty with forecasting



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Preparing for the change

Discovery

Dialogue
- Internal
- External

Review Lease Data
- Locate leases
- Develop abstraction standard
- Abstract lease terms and conditions

Impact Analysis
- Examine some leases or portfolio for impact
- Review planned leases
- External

Planning

Analyze organization impact
- Business Unit allocations
- Debt covenants
- Approvals
- Resourcing needs
- Technology platform

Modify operating standards
- Structure of lease terms
- Financing strategies

Design processes
- Reporting
- Estimates
- Integration

Implementation

- Support initial financial impact calculations
- Integrate with BU and RE teams for quarterly estimates
- Implement strategy for data collection and storage, reporting, and on going audit adjustments
- Reporting out of lease database

Anticipated behavioral shifts

Centralization

- Centralized process for all lease approvals
- Increased involvement and scrutiny by C-suite on CRE decisions
- Centralized control of real estate costs on the P&L

Strategic portfolio management

- Enhanced strategic planning
- Pressure for business to anticipate future needs with reasonable certainty
- Understanding of the true cost of flexibility
- Shift in how lease v. buy decisions are made

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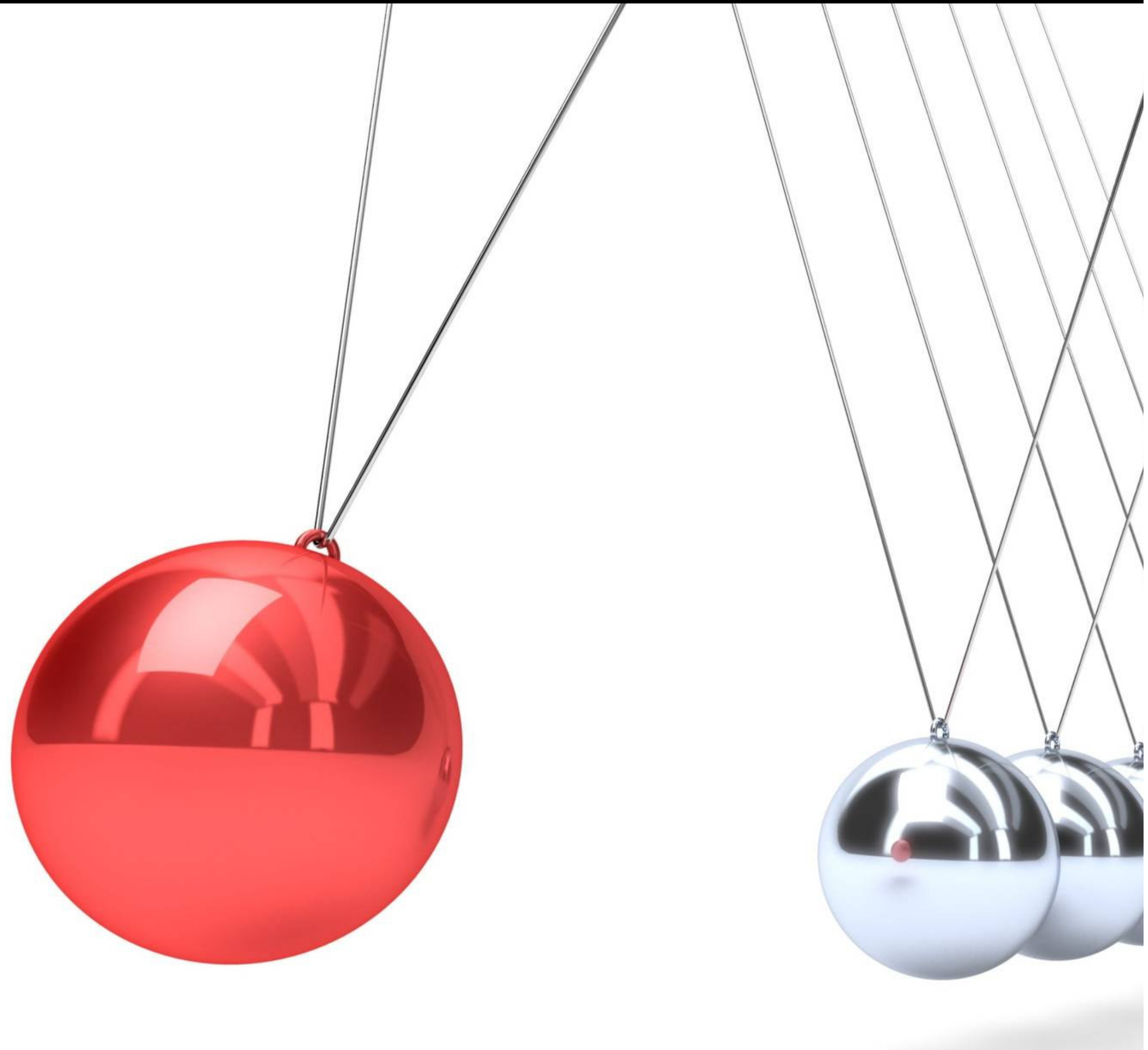
Questions



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Thank you