The Balance of Probabilities
Global Lease Accounting Changes

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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

- Discussion paper issued March 2009
- Re-deliberations commenced October 2009
- Comments submitted July 2009
- Exposure draft August 17, 2010
- Comments due December 15, 2010
- Final standard issued mid-2011
- Effective date of new standard – possibly 2013
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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?

<table>
<thead>
<tr>
<th>Financial statement</th>
<th>Operating lease</th>
<th>Finance lease</th>
<th>Right-of-use model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit and loss</td>
<td>• Lease rental</td>
<td>• Amortization</td>
<td>• Amortization</td>
</tr>
<tr>
<td></td>
<td>expense</td>
<td>• Finance expense</td>
<td>• Finance expense</td>
</tr>
<tr>
<td>Balance sheet</td>
<td>• Off balance</td>
<td>• Leased asset</td>
<td>• Right-of-use asset</td>
</tr>
<tr>
<td></td>
<td>sheet</td>
<td>• Finance lease liability</td>
<td>• Obligation to pay rentals</td>
</tr>
</tbody>
</table>

Will become obsolete
What will the new expense look like?

<table>
<thead>
<tr>
<th>Office Lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rentable Sq. Ft.</td>
</tr>
<tr>
<td>Initial Rent</td>
</tr>
<tr>
<td>Rent Increase</td>
</tr>
<tr>
<td>Lease Term</td>
</tr>
<tr>
<td>Corporate Borrowing Rate</td>
</tr>
<tr>
<td>NPV of Rents</td>
</tr>
</tbody>
</table>

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

Amortization + finance charge

20% higher year 1 rent!
P&L treatment

Year of Lease

Expense

End of Lease Term

Cash Rent
Rent Expense

JONES LANG LASALLE
# Balance sheet treatment

## Office Lease

<table>
<thead>
<tr>
<th>Rentable Sq. Ft.</th>
<th>100,000</th>
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<tbody>
<tr>
<td>Initial Rent</td>
<td>$14 NNN p.s.f.</td>
</tr>
<tr>
<td>Rent Increase</td>
<td>2% per year</td>
</tr>
<tr>
<td>Lease Term</td>
<td>6 yrs, 4-yr renewal option</td>
</tr>
<tr>
<td>Corporate Borrowing Rate</td>
<td>7%</td>
</tr>
<tr>
<td>NPV of Rents</td>
<td>$10,941,733</td>
</tr>
</tbody>
</table>

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Total $15,329,609

- 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

Discount cash rent by 7%
What will the new balance sheet look like?

<table>
<thead>
<tr>
<th></th>
<th>Year 0 – Current</th>
<th>Year 0 – New</th>
</tr>
</thead>
<tbody>
<tr>
<td>$m</td>
<td>$m</td>
<td></td>
</tr>
<tr>
<td><strong>Current Assets</strong></td>
<td>16,000</td>
<td>16,000</td>
</tr>
<tr>
<td><strong>Non-current Assets</strong></td>
<td>18,000</td>
<td>18,000</td>
</tr>
<tr>
<td><strong>Lease assets</strong></td>
<td>—</td>
<td>10,942</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>—</td>
<td></td>
</tr>
<tr>
<td><strong>Current Liabilities</strong></td>
<td>—</td>
<td></td>
</tr>
<tr>
<td><strong>Current lease liability</strong></td>
<td>—</td>
<td>(1,400)</td>
</tr>
<tr>
<td><strong>Non-current liabilities</strong></td>
<td>(4,000)</td>
<td>(4,000)</td>
</tr>
<tr>
<td><strong>Non-current Lease liability</strong></td>
<td>—</td>
<td>(9,542)</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>(16,000)</td>
<td>(26,942)</td>
</tr>
<tr>
<td><strong>Shareholders Equity</strong></td>
<td>18,000</td>
<td>18,000</td>
</tr>
</tbody>
</table>

### 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

**Basis for calculating finance charge**
- Liabilities / Equity
  - Existing leases: 0.89
  - Proposed leases: 1.5
- Debt / Equity
  - Existing leases: 0.22
  - Proposed leases: 0.75
- Liabilities / NCA
  - Existing leases: 0.89
  - Proposed leases: 1.5
- Current ratio
  - Existing leases: 1.3
  - Proposed leases: 1.19
Lessor treatment

Risks and benefits transferred to lessee?

No

Performance Obligation Approach

- 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

Yes

De-recognition Approach

- 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
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
Questions
Thank you