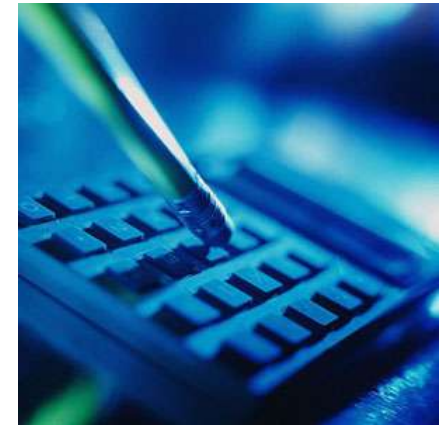


# Operating Leases – One Step Closer ...

## BREAKFAST SESSION

Thursday, 14 October 2010



### PROGRAMME

8.30am	Registration
9.00am	Presentation
10.00am	Q & A
10.30am	Close

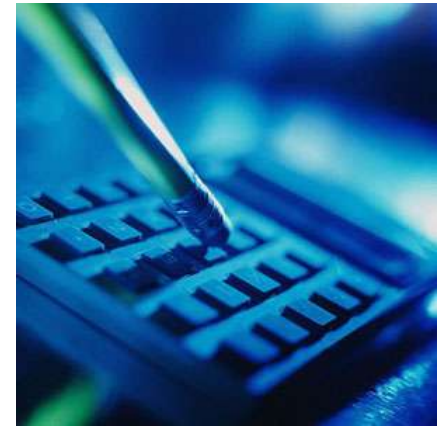
The UK Chapter is grateful to its Annual Sponsors:



# Upcoming Events

**Thin Client Technology – 1 Nov 2010**

**4i Forum Launch – November 2010**



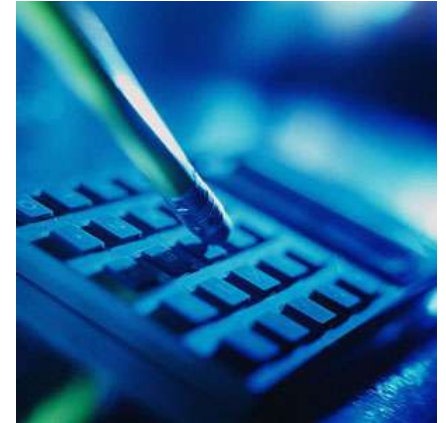
The UK Chapter is grateful to its Annual Sponsors:



# Alex Thorpe

Director of Programmes,  
CoreNet Global UK Chapter

[alex.thorpe@tpbennett.com](mailto:alex.thorpe@tpbennett.com)



The UK Chapter is grateful to its Annual Sponsors:



## Michael Evans

Director - Corporate Capital Markets  
Jones Lang LaSalle

## Rachel Knubley

Technical Principal  
International Accounting  
Standards Board

## Barbara Davidson

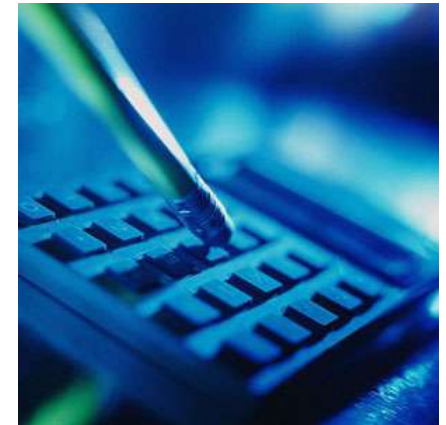
Technical Manager  
International Accounting  
Standards Board

## Richard Porter

Director - Corporate Capital Markets  
Jones Lang LaSalle

## Richard Drake

Financial Strategy Director  
Barclays plc



The UK Chapter is grateful to its Annual Sponsors:



# Agenda

**Rachel Knubley /  
Barbara Davidson**

Background

Scope

Lessee Model

Measurement

Lessor Model

Disclosure

Transition

Next Steps

**Richard Porter**

Financial Implications

Commercial Implications

What to do?

**Richard Drake**

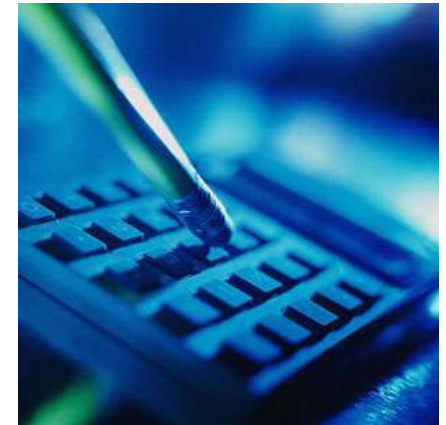
Which Leases?

Calculation issues

Reporting issues

FAQs

Other



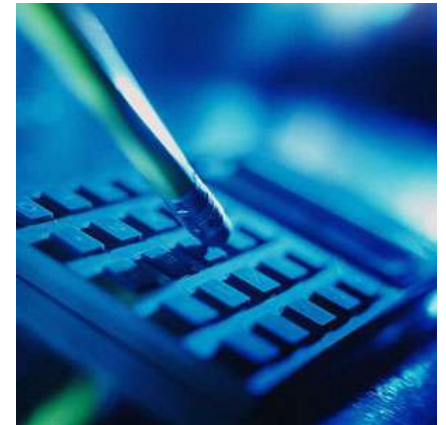
The UK Chapter is grateful to its Annual Sponsors:



# Rachel Knubley / Barbara Davidson

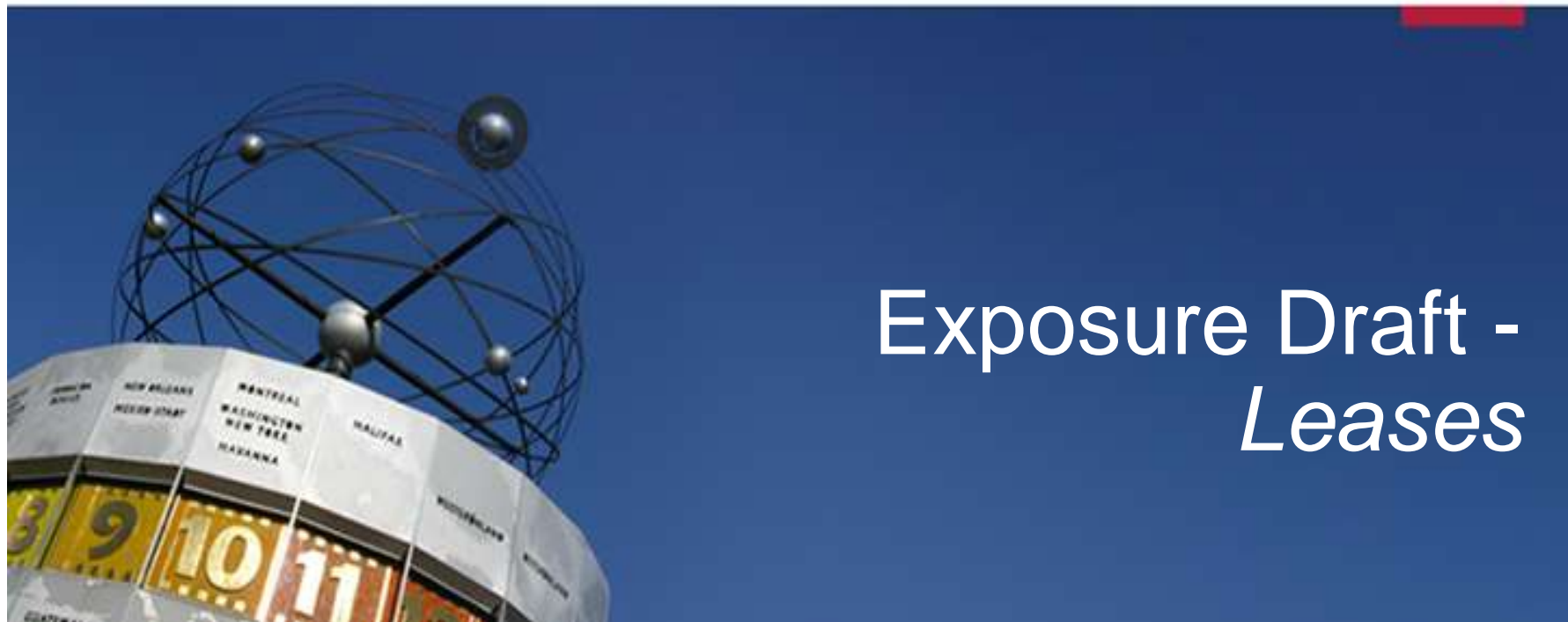
Technical Principal / Technical Manager

International Accounting Standards Board



The UK Chapter is grateful to its Annual Sponsors:





# Exposure Draft - *Leases*

The views expressed in this presentation are those of the presenter,  
not necessarily those of the IASB or IFRS Foundation

# Why a lease project?

---

- **Existing lease accounting doesn't meet users' needs**
  - Accounting depends on classification
  - Users adjust financial statements to recognise assets and liabilities arising in operating leases
- **Complexity**
  - Difficult to define dividing line between finance and operating

# Scope

---

- Excludes:
  - Lessors with investment property at fair value under IAS 40
  - Purchase and sale contracts
  - Leases of intangible assets
  - Leases of biological assets or to explore for or use natural resources
- Includes simplified accounting for short-term leases
  - Lessee: recognise gross asset and gross liability
  - Lessor: use accrual accounting
- Includes certain requirements for sale/leasebacks
- Incorporates IFRIC 4 to differentiate service contracts from leases

# Lessee model – Right of Use

Lessee has acquired a right to use the underlying asset and is paying for that right with its lease payments

All leases in scope			
<b>Balance sheet</b>		<b>Income Statement</b>	
• Right-of-use asset*	X	• Amortisation expense	X
• Liability to make lease payments	X	• Interest expense	X

\* Shown in the property, plant and equipment category

# Lessee measurement

	Initial Measurement	Subsequent Measurement
<b>Liability to make lease payments</b>	PV of lease payments discounted using incremental borrowing rate	Amortised cost No revision of incremental borrowing rate
<b>Right-of-use asset</b>	Cost (= liability to make lease payments)	Amortised cost (option to revalue*)

\*Revaluation of entire class of PP&E is required if right-of-use is revalued

# Options to extend lease term

---

- Include longest possible lease term that is more likely than not to occur
- Reassess if facts or circumstances indicate that there is a significant change
  - Adjust liability and right-of-use asset for lessees
- Purchase options
  - Account for only when they are exercised

# Contingent rentals

- Include expected outcome in lease asset and liability
- Include residual value guarantees
- Reassess if facts or circumstances indicate a significant change
- Adjust liability to make payments, and
  - **profit or loss *for changes related to current or past periods***
  - or
  - **right-of-use asset *for changes related to future periods***

# Options to extend and contingent rentals: potential concerns

Concerns	Response
<b>Options to extend</b>	
Subjectivity of judgement	Requirement to reassess (true-up information)
Renewals are avoidable –understates financial flexibility	Provides estimates of likely cash outflows
<b>Contingent rentals</b>	
Subjectivity of information	Requirement to reassess (true-up information)
Cost/benefit of determining information	Ignoring would lead to structuring
Reliable measurement	Some users prefer estimates to no information

# Lessor model – Right of Use

Does the lessor retain significant risks or benefits of the underlying asset?

No

Yes

## Derecognition approach

## Performance Obligation approach

### Balance sheet

- Right to receive lease payments X
- Residual asset X

### Balance sheet

- Right to receive lease payments X
- Underlying asset X
- Lease liability (X)
- Net lease asset (liability) X

(gross with linked presentation)

### Income statement

- Revenue X
- Cost of sales (X)
- Interest income X

(gross or net based on business model)

### Income Statement

- Depreciation (X)
- Lease income X
- Interest income X

(separate presentation –IASB)

# Lessors model - measurement

	Initial Measurement	Subsequent Measurement
<b>Derecognition approach</b>		
Right to receive lease payments	PV of lease payments discounted using the rate charged in the lease	Amortised cost
Residual asset	Allocated carrying amount	No remeasurement (except for impairment)
<b>Performance Obligation approach</b>		
Right to receive lease payments	PV of lease payments discounted using the rate charged in the lease	Amortised cost
Lease liability	Transaction price (= right to receive payments)	Recognise income as the liability is satisfied over the lease term

# Disclosures

---

- Identify and explain the amounts recognised in the financial statements arising from leases; and
- Describe how leases may affect the amount, timing and uncertainty of the entity's future cash flows.
- Include:
  - Nature of lease contracts
  - Accounting policy for models used (lessor)
  - Maturity analyses
  - Income recognition information
  - Discount rates
  - Roll-forward of right-of-use asset / liability to make lease payments (lessees)
  - Roll-forward of right to receive payments / lease liability or residual asset (lessors)

# Transition

- All leases
  - Simplified retrospective approach
  - Present value of remaining lease payments
  - Effective date: TBD

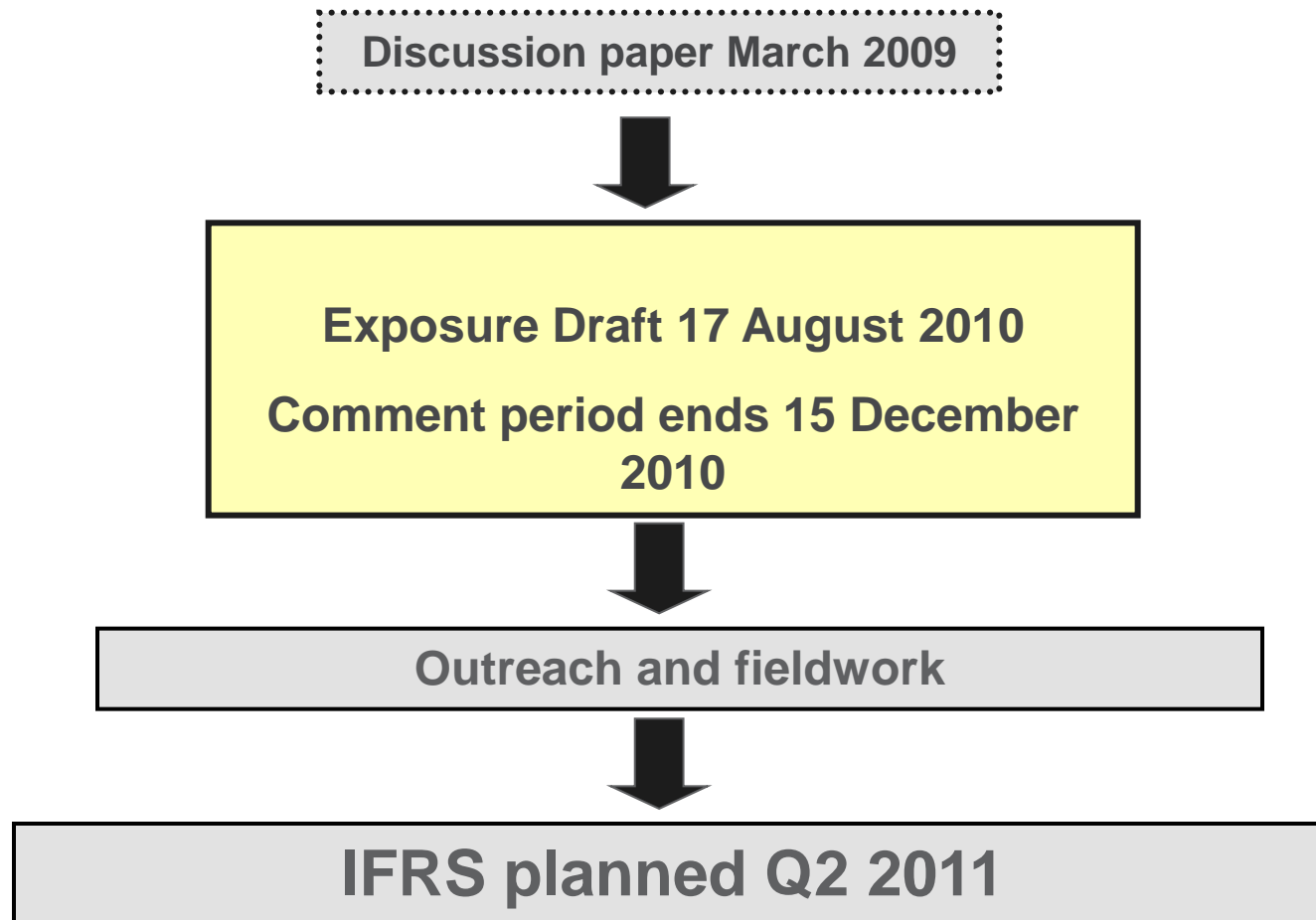
- **Lessee:**

Liability to make lease payments	=	Right-of-use asset	=	PV of lease payments
----------------------------------	---	--------------------	---	----------------------

- **Lessor:**

PO approach		Derecognition approach
Right to receive lease payments		Right to receive lease payments
Lease liability = PV of lease payments		Residual asset = Fair value

# What next?



# IASB contacts

---

## ***Outreach:***

- Barbara Davidson (Technical Manager): [bdavidson@ifrs.org](mailto:bdavidson@ifrs.org)

## ***Project team:***

- Rachel Knublely (Technical Principal): [rknublely@ifrs.org](mailto:rknublely@ifrs.org)
- Li Li Lian (Technical Manager): [llian@ifrs.org](mailto:llian@ifrs.org)
- Aida Vatrenjak (Assistant Technical Manager):  
[avatrenjak@ifrs.org](mailto:avatrenjak@ifrs.org)
- Sunhee Kim (Technical Associate): [skim@ifrs.org](mailto:skim@ifrs.org)

# Questions or comments?

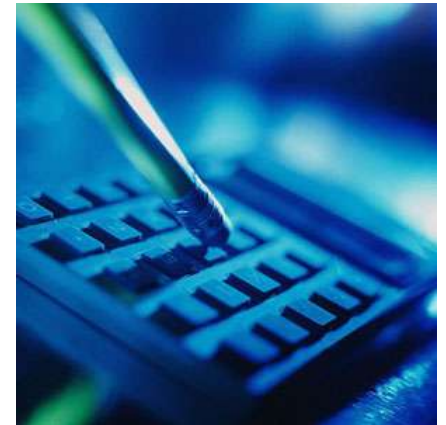
---

Expressions of individual views by members of the IASB and its staff are encouraged. The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.



# Richard Porter

Director - Corporate Capital Markets  
Jones Lang LaSalle



The UK Chapter is grateful to its Annual Sponsors:



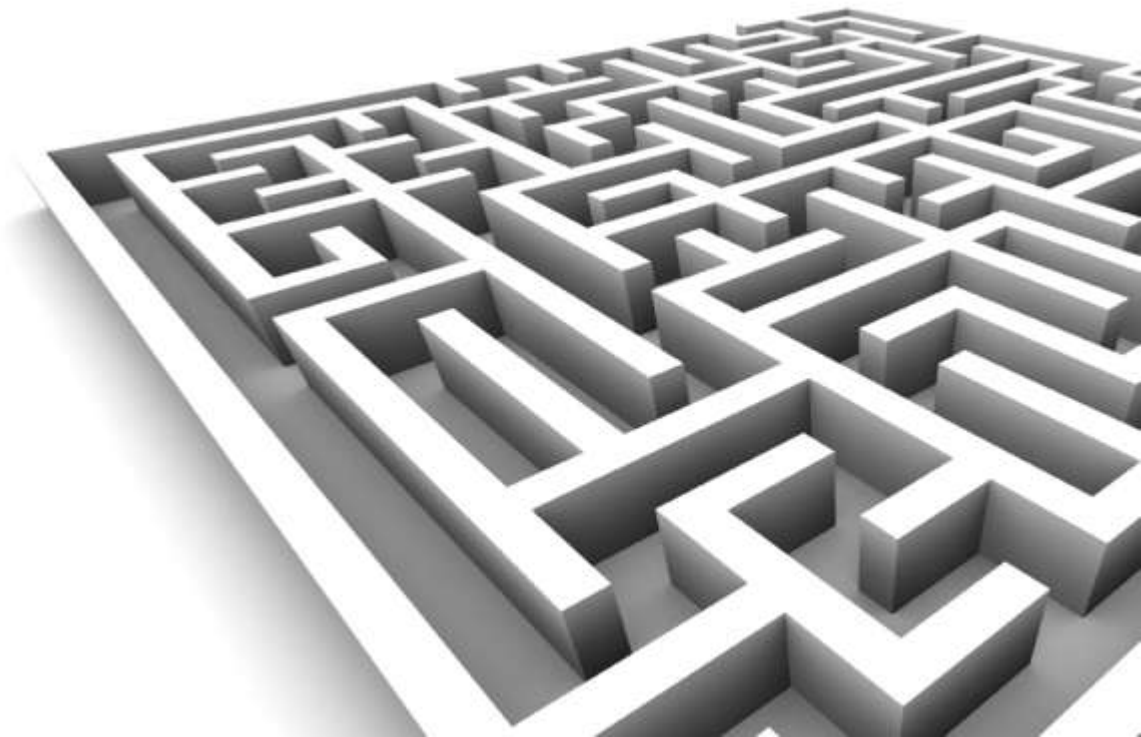
# Implications

Richard Porter - JLL



*Real value in a changing world*

- Financial – Today's Framework vs. Tomorrow
- Commercial Implications
- What should Corporates do?



# Operating Lease – Today's Framework

## Lessee accounting

- Rent is expensed in the P&L
- Obligation is not recorded on the Balance Sheet
- Underlying asset not recorded on Balance sheet
- Obligations usually reflected in the notes to the accounts
  - < 1year
  - 2 - 5 years
  - > 5 years

# Proposed Framework

Leases will be treated similar to Purchase with 100% financing:

- Liability on Balance Sheet, like a loan – “Obligation to pay rentals”
- Asset on Balance Sheet, like ownership – “Right of Use” Asset
- Asset depreciated (straight line) over term (or asset life if shorter)
- Rental Payments are split into Interest and capital
  - Capital element reduces the Liability over term
  - Interest is a P&L expense
- P&L cost is therefore
  - Interest
  - Depreciation of Asset

# Example

## Lessee accounting

- 10yr lease
- £1m p.a
- Incremental borrow rate - 5%
- Present Value - £7.7m
- No Breaks
- No Options to extend
- No Residual Value Guarantees
- Asset Life > 10 years

# Operating Lease – Example Today

<u>Profit &amp; Loss</u>	Year 0	Year 1	Year 2	Year 10
Rent		(1.0)	(1.0)	(1.0)
<b>P&amp;L</b>	<b>-</b>	<b>(1.0)</b>	<b>(1.0)</b>	<b>(1.0)</b>
<u>Cashflow</u>	Year 0	Year 1	Year 2	Year 10
Rent		(1.0)	(1.0)	(1.0)
<b>Cashflow</b>	<b>-</b>	<b>(1.0)</b>	<b>(1.0)</b>	<b>(1.0)</b>
<u>Balance Sheet</u>	Year 0	Year 1	Year 2	Year 10
Cumulative Cash		(1.0)	(2.0)	(10.0)
<b>Balance Sheet</b>	<b>-</b>	<b>(1.0)</b>	<b>(2.0)</b>	<b>(10.0)</b>

# Operating Lease – Example Tomorrow

## Profit & Loss

Year 0

Year 1

Year 2

Year 10

Depreciation

-

(0.8)

(0.8)

(0.8)

Interest Expense

-

(0.4)

(0.3)

(0.0)

P&L

-

(1.2)

(1.1)

(0.8)

P&L initially high, but falls over time



## Cashflow

Year 0

Year 1

Year 2

Year 10

Terminology TBC (Rent)

(1.0)

(1.0)

(1.0)

Cashflow

-

(1.0)

(1.0)

(1.0)

No different to Operating Lease Today

# Operating Lease – Example Tomorrow

## Balance Sheet

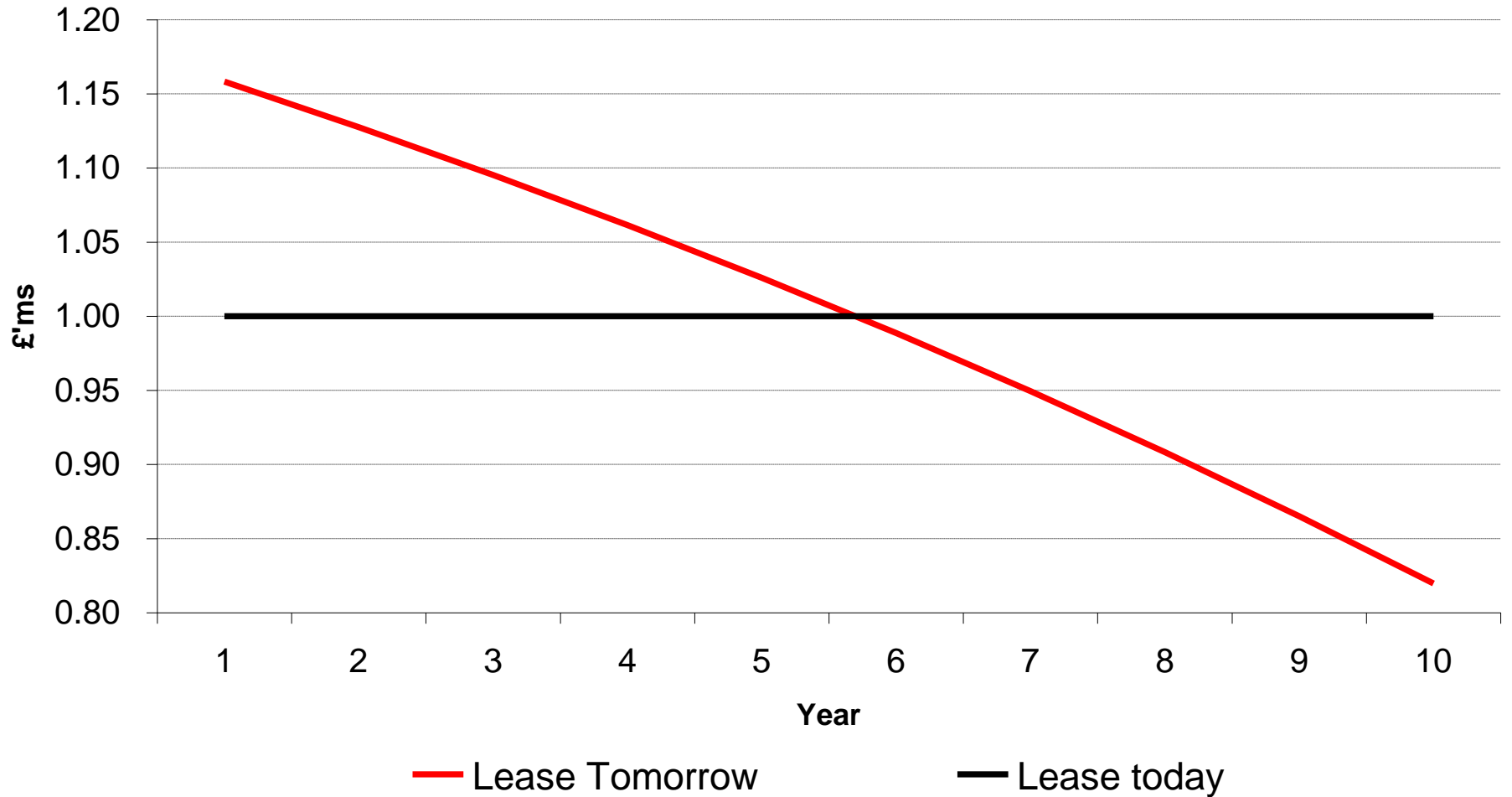
	Year 0	Year 1	Year 2	Year 10
Fixed Assets – “Right of Use” Asset				
Initial Capitalisation	7.7	7.7	7.7	7.7
Cumulative Depreciation	-	(0.8)	(1.5)	(7.7)
Net Book Value	7.7	6.9	6.2	0.0
Cash				
Cumulative Cash flow	-	(1.0)	(2.0)	(10.0)
Liabilities > 1 year				
“Obligation to pay rentals”	(7.7)	(7.1)	(6.5)	0.0
<b>Total</b>	<b>0.0</b>	<b>(1.2)</b>	<b>(2.3)</b>	<b>(10.0)</b>

# Impact on P&L

Lessee accounting

## 10 year Lease - P&L Comparison

- P&L front loaded
- Benefit after mid-point

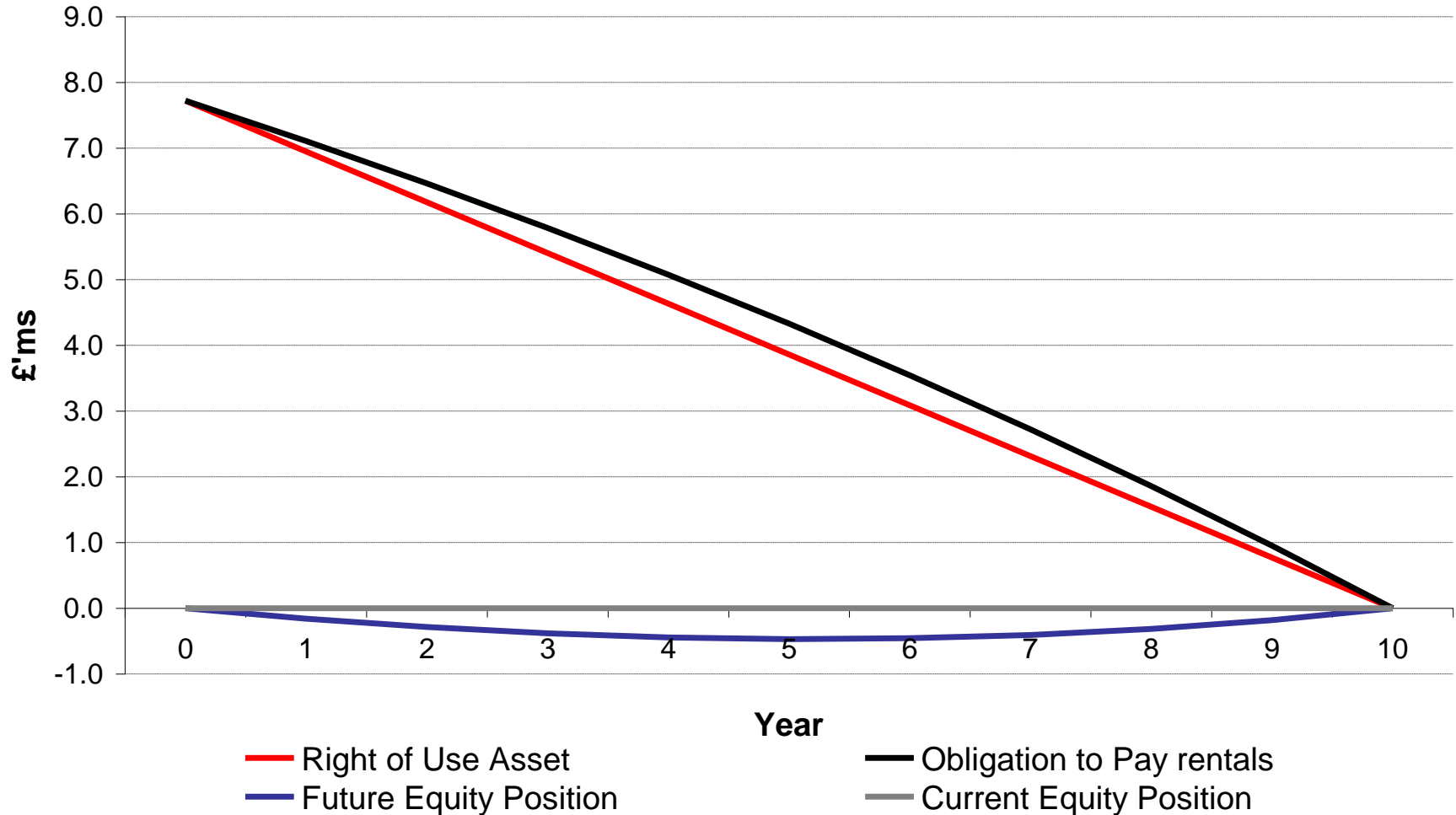


# Impact on Balance Sheet

- Liability > Asset
- Negative Equity

Lessee accounting

## 10 year lease - Balance Sheet Comparison



# Impact of Different Leases\*

Lease Length, Interest Rate and Uplifts

- Key Drivers
  - Term
  - Rental Growth
  - Rate

## Year 1 P&L Impact

	5 year lease	10 year lease	20 year lease
5% rate, no uplifts	8.2%	15.8%	24.6%
10% rate, no uplifts	13.7%	22.9%	27.7%
10% rate, 5 yearly 2% uplift	13.7%	27.8%	41.0%
10% rate, Annual 2% uplifts	17.9%	32.5%	46.0%

## Initial Liability

	5 year lease	10 year lease	20 year lease
5% rate, no uplifts	£4.3 m	£7.7 m	£12.5 m
10% rate, no uplifts	£3.8 m	£6.1 m	£8.5 m
10% rate, 5 yearly 2% uplift	£3.8 m	£6.4 m	£9.4 m
10% rate, Annual 2% uplifts	£3.9 m	£6.6 m	£9.7 m

# Own or Lease

## Impact of 10 year lease - Assumptions

### Lease (as before)

- 10yr lease
- £1m p.a
- Incremental borrow rate - 5%
- Present Value - £7.7m
- No Breaks
- No Options to extend
- No Residual Value Guarantees
- Asset Life > 10 years

### Ownership

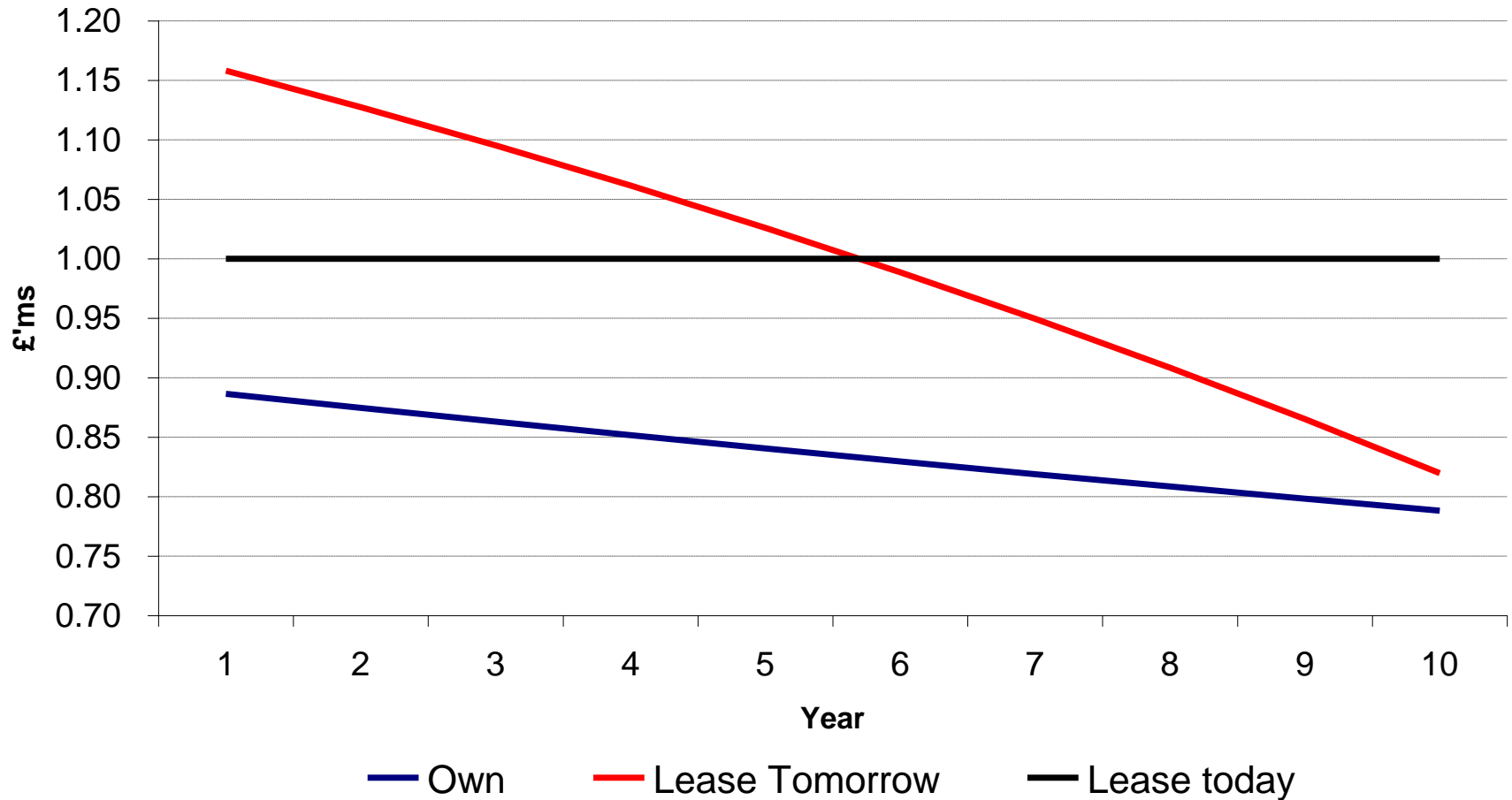
- 100% Corporate Debt Finance
- 5% Cost of Debt
- 8% yield (giving asset value of £11.8 m)
- 40 years depreciation life

# Own or Lease

Impact of 10 year lease

- Higher interest
- Lower Depreciation

## Own vs Lease - P&L Impacts



# Commercial Implications / Considerations

## Administration

- Increased burden – initial measurement and on-going monitoring
- Finance, business and real estate will need to work more closely
- Numerous decisions required
- Robust systems required to track and report
- Shift to increased outsourcing of lease administration?

## Accounting

- Shorter leases – less dramatic for P&L and Balance Sheet
- S&LB = “On Balance Sheet”
- Decisions more cash driven
- Debt loads will increase – impact on Debt covenants
- EBITDA will increase, PAT will decrease

## Strategy

- Move to Shorter leases? – Depreciation issues and landlord constraints
- General review of leasing policy
- Move to Ownership? – Depends on funding costs and buy-in price
- How will Analysts react to change in financials?
- Tax implications

# What should Corporates do?

## Administration

- **Determine appropriate administration**

- Centralise
- Resource requirements
- Indentify stakeholders
- Estimates input (internal vs. external)
- Create process for data collection
- Integrated process for reporting and tracking

## Accounting

- **Calculate / Assess impact on**

- Balance Sheet
- Profitability measures
- Analyst's perception
- Management vs. External Reporting
- Key Ratios (inc. debt covenant ratios)
- Capital Ratios

## Strategy

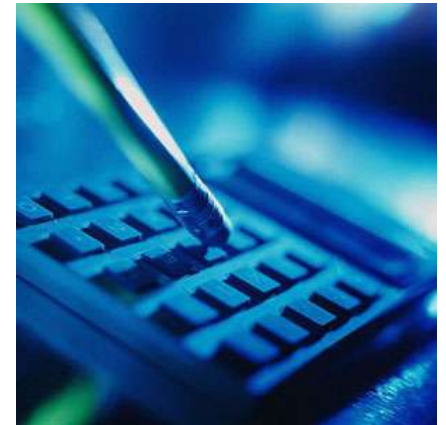
- **Key considerations**

- Entering into new lease
- Own vs. Lease
- S&LBs
- Buy in Opportunities
- Regearing leases
- Review general leasing policy

# Richard Drake

Financial Strategy Director

Barclays plc



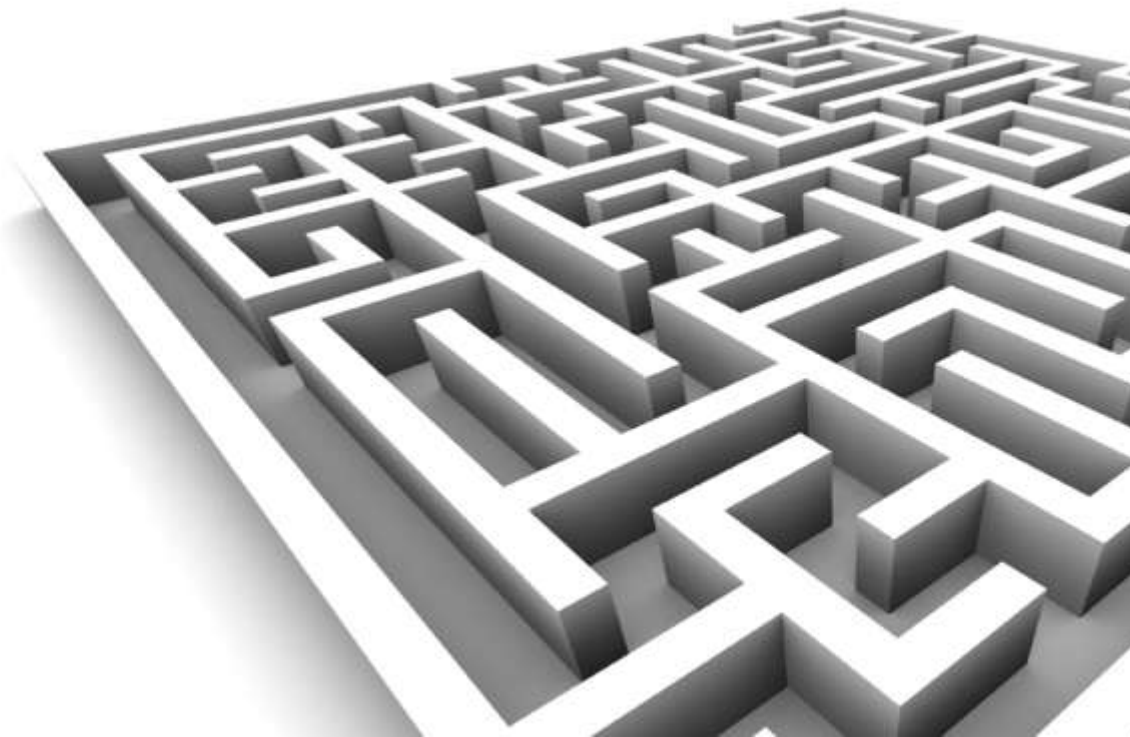
The UK Chapter is grateful to its Annual Sponsors:



# Corporate Occupier View

Richard Drake – Barclays Group Property

- Which Leases?
- Calculation issues
- Reporting issues
- FAQs
- Other



# Practical issues to consider

## Which Leases?

- Licenses/Short term leases (BUT you intend to stay)
- Multiple leases in individual buildings
- Valuable leases already treated as assets

# Practical issues to consider

## Calculation Issues

- Discount rate to use
- Lease term, break clauses, “most likely lease term” (NB the life you put on the fit-out is an obvious checkpoint)
- Future rent reviews

# Practical issues to consider

## Reporting Issues

- Management accounting
- Segmental reporting

(Will analysts use these numbers or still adjust)

# Practical issues to consider

## FAQs

- **Should we only sign short leases?** - Only if this suits the business strategy. Lease accounting will look at business intention and the commitment is that, NOT a shorter legal commitment. The economic life of the fit-out is a good guide to the lease length to be taken.
- **Should we buy-in freeholds?** - Only if an option AND the numbers work i.e. funding costs and equity required.
- **Should we still do sale & leasebacks?** - Again if the numbers work BUT only for the length of lease you need/want.

# Practical issues to consider

## FAQs

- **Why do we acquire/hold property?** - We acquire property to suit the business requirement for space, location AND if leased, time. Where possible options to exit early and/or extend should be obtained.
- **Reality check** – genuine choices between freehold and leasehold for new acquisitions are rare.

# Practical issues to consider

## Other Issues

### General

- Sub-tenanted space
- Surplus space
- Lease incentives
- Analyst view
- Existing lenders view

### Financial services

- Regulators view (WRAs)

# Summary

- Engage Finance Director / Finance and business colleagues
- Collect all the information on your portfolio
- Assess potential impact
- Engage with the process
- Ask questions



JONES LANG  
LASALLE®

*Real value in a changing world*



BARCLAYS

# Questions



The UK Chapter is grateful to its Annual Sponsors:

