

# *The overhaul of lease accounting*

Catalyst for change in  
corporate real estate

*The US GAAP  
edition*

*April 2016*



**Dear friends,**

The newly-released lease accounting standard affects all leased assets, from airplanes to copiers, and changes the reporting characteristics of such obligations. For companies that are heavy users of real estate, the rules related to the new standard may be an incentive to reconsider their real estate strategy. Implementation of the new rules may have a significant impact on the company's financial statements and require substantial changes to processes and systems.

Many companies, especially those that utilize significant real estate as part of their operations, are already reconsidering their real estate strategies. In many cases, this reconsideration is part of an effort to unlock shareholder value in existing assets or to provide growth capital for the continued expansion of capital-intensive industries. Increasingly, activist investors are driving these pressures, who are not likely to go away any time soon. The new lease accounting standard may serve to further increase the focus on real estate in general, and leasehold interests in particular.

Management at companies of all sizes and in all industries needs to be prepared to provide shareholders and investors with a well-articulated real estate strategy that is supported by a proactive assessment of the company's existing property portfolio, including both owned and leased assets. By telling a clear story and openly communicating with shareholders and investors, companies both minimize the risk of becoming an activist target and help to build shareholder value.

When you are evaluating your real estate strategy, for whatever reason, PwC can help. We can help you understand the new standards and the implications to your business, as well as help you consider the implications to your broader real estate strategy. Through our specialists' global presence and extensive knowledge of capital markets, PwC can also provide you with the insight you need to achieve increased organizational transparency for investors and shareholders. PwC offers a powerful combination of personal service, specialized experience, and global reach that sets us apart and helps you achieve your goals.



A handwritten signature in black ink, appearing to read 'Byron Carlock, Jr.' with a stylized flourish.

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## *Executive summary*

In preparation for the new GAAP leases requirements, or to be more nimble in the current economic climate, senior management at many companies are targeting their corporate real estate strategy and operations for major renovation and update. The existing corporate real estate function may have originally been designed to support a very different operational structure compared to what exists today, or may even have been originally motivated by financing or tax considerations that are no longer applicable. The changes to lease accounting may provide a catalyst for change to these operations that goes beyond adapting to the technical requirements of the accounting, and may include reconsideration of strategy and the potential engagement in real estate monetization transactions.

### *The coming changes*

The FASB and IASB have both recently issued new accounting standards that radically transform lease accounting. Unfortunately, while the boards worked together on the project and were previously largely aligned, they reached very different conclusions in certain areas, most significantly relating to the income statement

treatment of many leases. This divergence will cause complications for multi-national companies dealing with the different models in different jurisdictions. This publication deals predominately with the application of the FASB model and its implications on US reporting entities.

The changes in the new standard will affect almost every company. Under the new model, a lessee's rights and obligations under all leases (except short-term leases)—existing and new—will be recognized on its balance sheet. The income statement treatment will be based on the classification of the lease as either an operating lease or a finance lease, which are differentiated using rules largely similar to those applied today for classifying capital leases.

The effective date for calendar year end public business entities is 2019, with some relief on transition under several practical expedients. Upon adoption, prior comparative periods will need to be recast. For public business entities, this means 2017 and 2018 will need to be recast to reflect the impact of the new standard—which is right around the corner.

## Overview of the new leases standard

- The biggest changes were made to lessee accounting. Generally, pre-existing leases will not be grandfathered. Lessor accounting is substantially the same under the new standard compared to today's accounting.
- Essentially all assets leased under operating leases (except short term leases that are less than 12 months at lease commencement) will be brought on balance sheet. The lease liability will be equal to the present value of lease payments. A corresponding right-of-use asset will be based on the liability, subject to certain adjustments, such as for initial direct costs.
- For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. Operating leases will result in straight-line expense (similar to current operating leases), while finance leases will result in a front-loaded expense pattern (similar to current capital leases). Classification is based on criteria that are largely similar to those applied in current lease accounting, but without explicit "bright lines." While bright lines no longer exist, we believe that a reasonable approach may be to consider the previous percentages when determining lease classification (i.e., 75% of the economic life of the underlying asset and 90% or more of the fair value of the underlying asset).
- Lease accounting will continue to require significant judgment, including estimates related to the lease term, lease payments, and the discount rate. Similar to today, the term of the lease will include the noncancellable lease term plus renewal periods that are reasonably certain of exercise by the lessee or within the control of the lessor and periods covered by an option to terminate the lease that the lessee is reasonably certain not to exercise.
- Variable rent payments are generally excluded when assessing classification and when measuring the lease liability, except those based on an index or rate, which are included based on the index or rate at lease commencement. Subsequent changes to the index or rate (e.g., changes in CPI) and other variable payments will be treated similar to contingent rent today. A lessee will only reassess variable lease payments that depend on an index or rate when the lease liability is remeasured for another reason independent of a change in a reference index or rate. Lease incentives should be included in lease payments when classifying the lease and measuring the lease liability.
- When calculating present value, the applicable discount rate will be determined similar to existing leasing literature, except that lessors will be required to include deferred initial direct costs in their calculation of the rate implicit in the lease.
- Lessees will need to monitor for the occurrence of certain triggering events on an ongoing basis. For example, upon certain events under the lessee's control or an option that is exercised or not exercised as planned, the lessee must reassess the lease term. A change to the lease term may lead to reclassification of the lease and remeasurement of the right-of-use asset and lease liability. In such cases, assumptions related to variable rents based on an index or rate and the discount rate will be updated as of the remeasurement date.
- A lease modification may be accounted for as a modification to the original lease or as the creation of a separate lease. A lessor should not reassess the lease term or a lessee option to purchase the asset unless the lease is modified and that modification is not accounted for as a separate lease.
- Existing sale and leaseback guidance, including guidance applicable to real estate, is replaced with a new model applicable to both lessees and lessors. Existing sale and leasebacks will need to be addressed in transition – which may include recognizing previously deferred gains as an adjustment through opening equity as of the earliest period presented upon adoption.
- Financial performance ratios may be impacted and other new operating metrics may evolve as a result of the adoption of the new standard.
- For some companies, the new standard will require significant system and process changes prior to the adoption date.
- Companies with international operations many need to consider the impact of the new lease standard under IFRS. There are significant differences between the US GAAP and IFRS standards in that IFRS requires a single model in which all leases are treated as financing transactions.

At a minimum, compliance with the new standard may drive companies to consider significant upgrades, replacements, or overhauls of their legacy accounting systems, processes, and controls. Importantly, the new standard may also have a significant impact on a company's operating results, financial ratios, and debt covenants. The scope of areas impacted by adoption goes well beyond just financial accounting. Many companies are already starting to plan for the coming changes, which may have operational, legal, tax, and IT implications.

For some companies, the new lease accounting standard will represent just another compliance exercise, but one that is likely to entail significant cost and complexity. The cost of adoption is likely to include the education of all key stakeholders, robust systems upgrades, new processes, and implementation of new controls.

For others, the compliance exercise will serve as a much-needed catalyst for change in their overall corporate real estate strategies. Because the new model will eliminate the off-balance sheet accounting for existing operating leases, it may also eliminate some of the perceived accounting advantages of leasing. Thus, the new standard may be an impetus for many to overhaul their real estate strategies. Changes to strategy may include re-evaluating lease versus

buy decisions and considering the accounting ramifications of alternate lease structures. Such alternative structures could be different lease terms, variable rent (e.g., net lease structures over gross/modified gross leases for CAM/insurance/real estate taxes, leases based on CPI) or considering contingent rent over leases with increasing fixed rent payments.

For significant users of real estate (e.g., retail, healthcare, and hospitality companies), it will be critical to manage stakeholder relations during the transition to the new standard. Board members, analysts, and shareholders will have many questions about the potential financial reporting impact and necessary investments in new systems, processes, and controls. In addition, the significant changes to the financial statements, and the related changes in financial metrics, will require thoughtful investor/analyst communication and possible changes to compensation arrangements and debt covenants.

But it's not just the new leases standard that has management reconsidering their real estate strategies. The real estate industry has recently seen a variety of economic, tax, and business issues. In addition, activist investors are becoming much more aggressive in their advocacy for dramatic operational changes and alternate means of monetizing real estate assets.

Regardless of whether narrow changes are made to real estate strategies purely as a result of the new standard or more pervasive changes are made to be responsive to other macroeconomic and governance developments, management needs to begin the process now. Decisions made now, including leases being negotiated today, can have long-term implications. It's important for management to take decisive action after careful consideration and analysis.

Aside from the direct impact on financial statement presentation, the following section details some of the more pervasive ancillary business implications that may result from adoption of the new leases standard.

## Significant impacts

- **Stakeholder education.** Lessees will recognize a lease liability measured at the present value of future lease payments. This amount may differ from how analysts and credit agencies previously adjusted leverage ratios for the “debt-like” operating lease obligations disclosed in the footnotes.
- **Potential impact on financial metrics or indirect financial impacts.** While the dual model may often limit the impact on income-based performance metrics, it may impact other financial metrics that utilize balance sheet elements, for example, debt-to-equity ratios or return on assets metrics. Further, there may be indirect impacts caused by these changes. For example, recording significant additional assets may affect state tax payments, while changes to key metrics may alter incentive compensation payments or earn-outs and perhaps even impact legal or regulatory capital.
- **Decision points and data needs.** Except for short term leases, all leases will be on the balance sheet. Decisions about a lease’s structure will impact the amount of the right-of-use asset and lease liability as opposed to impacting whether it will be recorded on the balance sheet. Data needs for ongoing reporting and disclosure will change significantly.
- **Lease versus buy decisions.** Previously, some lease versus buy decisions may have been influenced by whether a transaction qualified for off-balance treatment. Given that virtually all leases will be reported on the balance sheet, companies may want to revisit their lease-versus-buy decision criteria.
- **Transition.** While not effective until 2019, prior comparative periods presented will need to be restated using a modified retrospective transition method, which requires the recognition of a right-of-use asset and lease liability at the beginning of the earliest comparative period presented in the year of adoption. Leasing software and systems may require upgrades and enhancements, which may require a significant runway to adequately prepare for transition.
- **State tax liabilities.** Changes to the reported asset balance may impact income apportionment among states, potentially attracting additional income to higher tax jurisdictions. State capital and net worth taxes may increase as a result of the changes in the balance sheet.

## Opportunity

The last several years have seen a host of changes facing corporate real estate organizations. From cost management to outsourcing to systems changes to designing the workplace of the future, the role of the corporate real estate department has never been more complex. Nevertheless, the role of corporate real estate as a strategic function within an organization has often been overlooked or has not kept pace with the changes in the rest of the organization or market conditions.

Simply put, many senior executives and boards of directors have not viewed their corporate real estate departments as a significant element in driving the success of an organization. Recent focus on real estate monetization has begun to change those views. The advent of the new lease accounting standard may further spur changes in this mind-set.



# Reconsidering corporate real estate strategy

## Some fundamental questions

As discussed above, this is a dynamic time for those in the real estate industry or with significant investments in real estate. On top of the need to adopt the new leases standard, economic, business, and tax changes, have all combined to make it an ideal time to reconsider whether your organization has the appropriate real estate strategy. As you assess your current corporate real estate strategy, there are a number of fundamental questions that should be asked, such as:

- Do you have a strategy for your real estate assets that supports the business' wider strategic objectives?
- How do you hold your real estate assets as part of your capital structure (e.g., do you use intercompany leasing)?
- What are the drivers of your lease versus buy decisions?
- Do you have detailed information about all of your lease obligations?
- What are current market opportunities (e.g., lease rates/purchase prices) and how would they affect your real estate strategy?
- How do federal, state, and local taxes factor into your corporate real estate decisions?

- How does your company manage occupancy costs?
- What is the potential impact of the new lease model on your company?
- Do your company's existing systems have the capabilities necessary to capture and aggregate the information necessary to satisfy the reporting and disclosure requirements of the new lease standard? Are system, process, control and personnel changes necessary?

## Functional participation

Corporate real estate activity affects a number of key functional areas and any reconsideration of your approach should include, at a minimum, members of each of the following key constituencies:

- Accounting/reporting
- Treasury
- Legal/regulatory
- Operations
- Tax planning and reporting
- Information systems
- Human resources (e.g., impact on compensation agreements)
- Investor relations

Each of these functional areas may be impacted by the new accounting standard. Accordingly, many companies that are significant users of real estate are considering creating a “steering committee” comprised of individuals from each of these constituencies to help them consider the implications. A collaborative approach from the inception of the planning stage is vital to ensure that unexpected implementation issues are identified early in the process.

Many companies quickly identify some of the more significant transition impacts, such as the significant change in financial reporting or the potential impact on debt covenants and other metrics. However, other less obvious impacts also exist for particular companies or industries. In addition to the business implications detailed in the prior section, many companies will need to allow for incremental time and effort associated with executing leases as both lessors and lessees negotiate to achieve the most desirable accounting impact under changing dynamics. Accordingly, it is essential for companies to seek broad participation in the process of identifying and addressing the potential implications of the new lease accounting standard.

## Factors that impact corporate real estate strategy

The new standard will be the catalyst for companies to take a fresh look at factors that influence their corporate real estate strategy, which is influenced by a variety of factors, as represented below.



### The impact to corporate real estate strategy

- Reassess “lease-buy” decision criteria where buying is feasible
- Consider negotiation strategy around lease term - controlling space/economics versus accounting effect
- Consider pricing implications of option periods versus longer terms
- Consider common contractual terms and modify where appropriate - what is the “new normal”? (e.g., should you increase or eliminate certain contingent rent provisions)
- Evaluate the economic impact on more than just financial reporting, including regulatory capital, cost plus contracts, etc.
- Evaluate the tax impact, including federal, state, local and foreign taxes

Many companies are looking for a simple answer to the question, “how should we change our real estate strategy?” Unfortunately, the answer is, “it depends.” As we will discuss further, the decisions around when and how to lease are affected by a large number of factors, including the need to control particular assets, operational flexibility, availability of alternatives, common industry practices, tax and regulatory impacts and expectations of management. Careful consideration of the impact and the company’s specific circumstances will be required. It is not a “one size fits all” evaluation for all companies or for different types of transactions. Rather, management should be armed with an understanding of the impacts of the new model so they can create various strategies for major classes of transactions and then be able to apply those to specific situations as they arise.

## Operational issues

A company’s need for corporate real estate is driven in large part by both its current and planned physical requirements. Space needs can change dramatically over time—driven by a variety of factors, including growth/contraction plans, potential acquisitions, productivity improvements, and physical obsolescence. Further, local demographics may change needs for particular locations. These issues will vary significantly from company to company and by property type. The following examples help illustrate the

diversity of potential issues based on a company’s operations:

### Example 1—Retail company

A retail company typically requires several different types of property for its operations, including (i) store locations (ii) warehouse locations, and (iii) key corporate offices in central business districts.

### Example 2—Bank

Banks normally maintain a variety of property locations for their operations, including (i) bank branches (ii) processing operations (often in fungible office space in suburban markets), and (iii) key corporate offices in central business districts.

Generally, a company is more likely to lease real estate when its long-term property needs are unclear; operational flexibility is highly desirable and expected access to acceptable alternatives is good. Leasing has also historically carried the added advantage of providing companies with a form of off-balance sheet financing, which will generally not exist under the new standard.

Conversely, a company is more likely to buy when the company’s long-term property needs are clear, the need for specific properties are expected to be stable and long-term, specific assets are needed and/or there are concerns with respect to the availability of acceptable alternatives. Expectations regarding capital appreciation of real estate assets may also drive decisions.

There are also many operational reasons why companies rent rather than own that may be unrelated to the accounting or even to the economics. One such reason frequently cited is that leasing allows tenants to avail themselves of professional property management. Does a bank, for example, want to maintain a staff of engineers, maintenance, or other personnel necessary to address the day-to-day issues surrounding management of real estate? In these circumstances, we may begin to see an expansion of service options that may be included in property management contracts.

Overriding operational considerations is often the impact of market practice or practical availability of property for purchase. Certain types of properties (e.g., retail store locations) may be unique and not generally available for purchase, whereas commercial office space may be more fungible and, in some cases, also more available for purchase.

With the loss of off-balance sheet accounting under the new standard, companies that presently lease may instead opt to own. Companies with low leverage and high credit ratings may have a substantially lower cost of capital than traditional real estate lessors, which may create a capital arbitrage benefit for owning rather than leasing in certain cases. Although counter-intuitive, under the new standard, companies with a better credit profile and lower borrowing costs will record a larger lease liability as a result of discounting the associated

lease payments based on a lower incremental borrower rate when compared to a company with a lesser credit and higher borrowing costs, relative to the same lease.

We have already begun to hear of increasing potential purchase transactions involving single-tenant office buildings. It is possible that we will see an increase in certain property types converting portions of property to condominium interests as a result of the new standard.

However, this trend will be affected by the underlying reason companies are leasing, as discussed previously. It is also likely to vary significantly by property type. For example, converting portions of properties to condominium interests is more likely to occur for longer-dated leases in more physically static situations such as individual floors or blocks of floors in large office buildings or with single-tenant retail sites, both of which may be functionally independent. It is less likely to occur in relatively short or moderate duration leases with partial floors or in malls/strip centers, which are not functionally independent and may frequently require reconfiguration to accommodate a different tenant mix.

It is also interesting to note that this potential push towards more real estate ownership as a result of the new lease standard is, in fact, counter to the recent real estate monetization trends, which are having the effect of driving real estate assets off corporate real estate user's balance sheets. While the jury is still out, many market participants believe that the monetization trends will be the bigger

influence and the ownership trend driven by the accounting ramifications will be secondary.

Today, in many cases, companies outsource their corporate real estate lease administration because commercial real estate service providers offer this service relatively inexpensively (in order to gain access to more lucrative transaction activity, such as leasing commissions). Outsourcing may be more cost effective than doing such administration in-house. However, in some cases, the additional information needed to account for leases under the new lease model may be sensitive to the company's lease negotiating position. Companies may be hesitant to allow such interested parties to have the necessary access to the information in order to prepare the required accounting documentation.

### ***Economic issues***

While the real estate market has generally improved over the past several years, not all of the impact from the financial crises in 2008 has been reversed. Vacancy rates for some property types and in some markets are stabilizing, but not uniformly across all property type or markets. Further, many property owners continue to struggle with declining cash flow from operations, liquidity issues, high fit-out costs, and to a lesser extent, near-term debt maturities. As a consequence, landlords may be interested in discussing asset sales and lease modifications—perhaps by trading a lower rent in exchange for a longer lease (i.e., so called “blend and extend” transactions).

Accordingly, the current environment presents both challenges and opportunities for users of corporate real estate. In certain cases, opportunities to buy assets at favorable prices may still exist, while in other cases, negotiating rent concessions currently or through “blend and extend” type transactions may yield lower “all-in” occupancy costs. Although these market issues exist irrespective of the potential impact of the new lease accounting model, the new standard focuses a spotlight on the issues as companies consider the implications of the new accounting rule.

### ***Financing issues***

For many industries and individual companies, alternative financing options to leasing may be limited or too expensive. As a result, leasing, historically, may have been the only option available, or, it may have been cheaper than other sources of financing available to the company. In many cases, this will not change irrespective of the accounting ramifications.

However, depending upon the credit quality of the company, corporate real estate departments may now want to reconsider purchasing assets that were previously subject to a lease. When underwriting the amount and terms of a commercial mortgage to a property owner, lenders will consider factors such as debt yields, coverage ratios, loan-to-value, the length of lease terms, likelihood of renewal, and credit quality of the tenants occupying the property. In some cases, the property owner cannot effectively fund property improvements necessary for

the current operation of the property. A corporate real estate user/tenant (lessee) may have a better credit profile and lower cost of capital as compared to a particular property owner/landlord (lessor) or to the “average” credit in a pool of tenants at a site. If the tenant is committed to a longer term use of the property, such tenant may benefit from obtaining financing using its own credit rating versus the landlord’s, which may be lower as a result of current market difficulties.

Many of these issues are also the drivers of the recent monetization trends. Companies may, in fact, want to sell a property subject to a long-term lease back at a high valuation and effectively monetize an asset using its own credit to drive the valuation. Under the new model, this will involve an evaluation under the new sale and leaseback rules and a new lease-related asset and liability will come on the books, even if it’s a qualified sale and leaseback.

## **Tax considerations**

Federal and state tax considerations often played a significant role in many corporate real estate strategic decisions. A clear understanding of the tax motivations and implications for both counterparties in a transaction is critical, as these factors may significantly affect the pricing as well as the range of transactions the parties may be willing to consider. In addition, the economic issues affecting either side of a transaction may have radically changed since the decisions were first made. A company with net operating losses may be more willing

to undertake substantial restructuring to accelerate tax benefits or utilize the losses before they expire. A company with expiring capital loss carryovers may be seeking opportunities to generate gains. Tax sensitive transactions by entities with significant owned real estate are generating more interest once again—including sale and leasebacks, joint ventures, spin-offs, and real estate investment trust (REIT) conversion transactions.

In most cases, federal taxes will remain unchanged; however, significant federal deferred tax adjustments may need to be tracked as the related book amounts change.

For state income tax purposes, business income of a company is apportioned among the states by means of an apportionment formula. For states that utilize a property factor in the apportionment formula, the new lease standard may affect the amount of business income apportioned to a state. In general, a property factor includes all real and tangible personal property owned or leased by the company and used during the tax period in the regular course of business. In most states, property owned by a taxpayer is valued at its original cost and property leased by the taxpayer is valued typically at eight times its net annual rental rate. Certain states’ tax codes provide that federal income tax rules apply when determining the property factor. Others, such as New Jersey, do not follow the federal income tax treatment and determine property factor values based on book value. Companies doing business in these states may have historically taken financial statement rent

expense and applied a multiple when calculating property factor values. In such instances, the change in lease accounting may affect the calculation of the property factor, as companies may instead utilize the right-of-use asset to determine these values. Further, the compromise to allow for straight-line expense recognition for certain types of leases, including many property leases, actually slows down the amortization of the right-of-use asset and, as a result, may exacerbate the state tax issue.

Depending on the facts and circumstances of the company’s specific portfolio, the impact could be an increase in state taxes if the relative allocation moves income from lower tax jurisdictions to higher ones. Of course, the reverse could also be true if the relative allocation moves from higher tax jurisdictions to lower ones. Unfortunately, however, the states with higher rental rates (and therefore higher rental assets under the new model) are also generally the states with higher taxes - thereby creating an expectation that in many cases, a state tax increase will result from the change in apportionment. Accordingly, a detailed analysis to consider these state tax impacts using the company’s fact pattern may be necessary in order to devise a plan to minimize the impact.

State franchise/net worth taxes may also be impacted by the new standard. Certain states, such as Illinois, determine the value of a company for franchise tax purposes using US GAAP. In addition, this value may be apportioned to the state by use of a property factor, which is also calculated under GAAP principles. As a

result, net worth taxes in certain states may increase due to the increased value of property reflected on the balance sheet.

Items that may be impacted include the applicable depreciation rules, specific rules limiting the tax deductibility of interest (for example, thin capitalization rules and percentage of EBITDA rules), existing transfer pricing agreements, sales/indirect taxes, and existing leasing tax structures (in territory and cross-border). A reassessment of existing and proposed leasing structures should be performed to ensure continued tax benefits and management of tax risks.

Internationally, the new lease accounting model may have other impacts on the tax treatment of leasing transactions. In many jurisdictions outside the United States, tax accounting for leasing is often based on accounting used for book purposes, which may be under the IASB's new standard. Refer to the "International divergence" section below. Given that there is no uniform leasing concept for tax purposes, the effect of the new standard will vary significantly, depending on the jurisdiction.

When tax does not follow the accounting model prescribed by the new standard, management may see an increase in the challenges of managing and accounting for newly-originated temporary differences, which will generate new deferred taxes in the financial statements.

Timely assessment and management of the potential tax impact will help optimize the tax position by enabling entities to seek possible opportunities and/or reduce tax exposures.

## **Regulatory issues**

In some cases, the decision to lease was driven by regulatory issues particular to certain industries. For example, reimbursement rates paid on some government contracts are based on GAAP reporting. Today, for some contracts, the government will reimburse 100% of the cost of rent but will not reimburse for capital related items, such as interest and amortization/depreciation of owned real estate. With the elimination of the current operating lease model (where "rent" expense is replaced by amortization and interest – presented as a single line "lease expense"), government contracts and/or reimbursement rules may need to be modified to ensure that the intended economics of the arrangement continue. While regulators may ultimately view rent and lease expense the same, it is unclear at this point whether or how actual government regulations will be modified.

While the standard was still in a proposal phase, regulators were unwilling to provide an opinion on the potential regulatory implications until the standard was final and its effects were better understood. What is uncertain at this point is how regulatory agencies will react to the impacts this change will have on risk-based capital requirements and other key regulatory metrics. The effect of the change could be very significant to banks/broker dealers (see also "Intercompany Issues") and other regulated entities whose capital ratios and/or other metrics are closely monitored and that would be adversely affected if computed under the new model. Historically, banking regulators

have provided limited relief for the impact of such accounting changes. While the lessor operations of many banks will not be significantly affected, those with significant lessee activity (e.g., bank branches, headquarter buildings, processing centers, and ATM locations) may be impacted. Based on initial discussions with regulators, there may be an adverse impact of adoption of the new standard on risk-based capital requirements. However, the specifics remain unclear as of now.

## **Intercompany issues**

Many heavy corporate real estate users utilize a central real estate holding entity for owned and leased property, and then provide for intercompany charges to the consolidated subsidiaries using such assets. In some cases, the structures have been created (i) to take advantage of beneficial pricing (allowing companies to aggregate subsidiary needs to take bigger spaces), (ii) to obtain operating synergies and negotiate better terms, and (iii) for operational ease (allowing corporations with multiple subsidiaries to be flexible in allocating space between these units). It also may be driven by tax considerations (e.g., private REITs with beneficial state tax impacts). In some cases, companies execute intercompany leases, but, in others, no formal arrangement exists and costs are allocated through an intercompany expense charge. Under the new standard, these intercompany transactions will need to be reflected on each consolidated subsidiary's books, which may affect them from a regulatory standpoint (e.g., subsidiary broker dealers may be inadequately

capitalized). The documentation of the arrangement will be much more important since it will drive the value of assets and associated liabilities for entities reporting on a stand-alone basis.

## ***Governance, budgetary issues, and investment alternative issues***

Some historical decisions to lease versus buy may have been driven by approval protocols and budgetary factors. For example, when a company is growing rapidly, it might have been faster and more efficient to execute a lease of real estate or equipment rather than going through the process to approve the purchase of a capital asset. In addition, internal budgeting may have led to a leasing bias since the upfront cash outlay is much lower than a purchase. If the approval rules follow the new lease model, an operating lease may now need the same level of approval as an outright purchase.

In addition, some decisions to lease may have been driven by a company's prior alternative investment options for available cash. Today, many companies are holding significant cash balances that are earning only nominal returns. In the near term, using some of this cash to buy certain types of assets—especially ones expected to be utilized for a substantial portion of their lives—instead of paying much higher implicit rates in leases would be accretive to earnings in the long term. However, because existing leasing activity under today's operating leases

may not be visible to corporate treasury departments, this alternative use of cash may not be in focus and these opportunities may be missed.

## ***Managing corporate real estate***

In many organizations today, the corporate real estate department is viewed as more of an administrative function or “cost center” rather than a part of a strategic function or a competitive advantage. Further, corporate real estate departments may not have the infrastructure or systems to effectively track and manage the information necessary to make the various decisions, estimates, and periodic remeasurements required by the new standard. In some cases, they may not previously have been notified of changes, such as with regard to the expectations of renewals, on a timely basis.

Many companies that operate as a group of decentralized subsidiaries or ones that have grown larger through acquisition with significant legacy systems, may be challenged to capture, understand, and manage the necessary information related to real estate leases on a company-wide or even country-wide basis. Such systems may not be fully integrated into the larger enterprise-wide systems, including accounting and reporting. In addition, because of the length of a typical real estate lease, current management may not be aware of the original rationale for specific decisions, some of which may no longer exist due to changing circumstances. Changing

this environment to a more centralized one may require significant cultural changes that may not be easy to accomplish.

In some cases, corporate real estate departments may have the responsibility for tracking real estate, but not enough resources and focus to (1) identify and manage excess capacity, (2) identify and seek reimbursement for overcharges for lease operating costs (e.g., common area maintenance and bill back overcharges), and/or (3) minimize other cash real estate occupancy costs. Finally, for many companies, existing tracking systems are informal, incomplete, or inaccurate. These “tracking systems” might be nothing more than a drawer for storing copies of leases, a notebook containing lease abstracts, spreadsheets, and non-integrated or out-of-date software applications.

Few companies today track property, plant, and equipment in a manual fashion. Yet, many companies are still accounting for their leases of corporate real estate using spreadsheets and accounts payable systems with no formal corporate real estate asset management system for these leased properties. Even for the more sophisticated corporate real estate groups that have asset management systems, these systems are often freestanding and utilized more for lease administration purposes, with no integration with the company's accounting systems.

Some companies may be able to adapt to the new information needs without significant upgrades or integration, but to do so would miss an opportunity to automate a previously labor-intensive activity and free up employees for other more productive uses. For example, under certain circumstances, the new standard will require the remeasurement and reallocation of consideration (e.g., between lease and non-lease components), creating the need to track additional new lease information. Given the additional complexities associated with the detailed tracking required for both the balance sheet and income statement accounts, efficiencies can be gained from enhancing system support and automation.

From a long-term sustainability perspective (for companies with substantial leasing activities), spreadsheet-based accounting may not be practical because of the significant maintenance required and resultant susceptibility to error. High-volume corporate real estate users will likely need new systems/processes to create a documentation trail of the initial judgments and track subsequent changes in estimates or assumptions. The system will also need to be largely automated to calculate any resulting computational adjustments. Full integration into the company's control structure and accounting systems will be necessary, as will the ability to generate the extensive quantitative information for the mandated disclosures.

## **Internal controls and processes**

Many entities may not have robust processes and controls for leases, other than those related to initial classification and disclosures. In addition, the existing lease accounting model (absent a modification or exercise of an extension) did not require leases to be periodically revisited. The new standard requires leases to be remeasured for certain changes in estimates (for example, for certain changes in the expected lease term). Processes and controls will need to be designed or redesigned to ensure proper management and accounting of all lease agreements. Such processes and controls need to address the accounting and reporting at inception and over the lease term, as well as provide for the monitoring of events both in and outside of the lessee's control that may trigger incremental accounting or remeasurement.

Initial recording on balance sheet, subsequent recognition of expense in the income statement, and the potential for remeasurement, reallocation, and reclassification of the lease and lease-related assets and liabilities will likely require complex changes to existing processes and internal controls, including support for significant management assumptions. Monitoring and evaluating the estimates and updating the balances may also require more personnel than currently available.

The timely assessment and management of the impact of adoption on processes, controls, and resource

requirements will help reduce reporting risks. This includes ensuring adequate processes addressing the accounting in the related areas of tenant improvements, impairment evaluation, and tax accounting.

## **International divergence**

As previously indicated, the IASB issued its new lease accounting standard on January 13, 2016 with a similar adoption date. While current lease accounting by lessees was largely aligned under current rules, the IASB's new standard creates some significant points of additional divergence from US GAAP. Most notably, while both standards put leases on balance sheet, the IASB adopted a single finance model for income statement purposes. Accordingly, US multi-national companies may need to track both models if they have to report on IFRS or other international standards for statutory purposes and then report on US GAAP for consolidated purposes, or vice versa. This will also add complexity to tax accounting.

## **IT and lease accounting systems**

IT and lease accounting systems in the marketplace are based on the existing risks and rewards concept. They will need to be modified to the new right-of-use concept. While software developers have been working on designing systems to fully meet the needs of this new standard, these systems are not up and running

yet – although some systems may capture some or all of the underlying data that may be needed to do the necessary computations. Development and implementation of suitable new modules or systems is likely to require significant lead-time. Lessees will have to account for and manage lease agreements differently (including existing operating lease agreements). They may need to implement contract management systems for lease agreements and integrate these with existing accounting systems. The IT and accounting solutions will need to be sufficient to meet both their current and future needs. In addition, if a company also has significant subleases, additional complexities will arise, as the company will be applying both lessor and lessee accounting.

Lessees may expect lessors to provide them with the necessary information to comply with the new leasing standard. However, lessors may not have, or may be unwilling to provide, the data requested by lessees. Consequently, lessees will need to capture such information themselves and may need to modify their systems accordingly.

Timely assessment and management of the impact on IT and lease accounting systems will help reduce business and reporting risks. We understand that some of the ERP systems providers are in the process of evaluating and developing upgrades and solutions that will allow for the accounting and reporting requirements of the new standard and related controls.

## **Financial reporting and impact on ratios**

The financial statements will require restatement for the effect of the changes. The effects of the new standard should be clearly communicated to analysts and other stakeholders in advance. Transition disclosure requirements as to the potential implications of the new standard are already required. While initially most companies will say they are considering the impact of the new standard, as the date of the adoption gets closer, the disclosure of the potential implications is expected to be more granular and explicit.

Ongoing accounting for leases may require incremental effort and resources as a result of an increase in the volume of leases recognized on balance sheet; there is also a need to monitor events that may trigger reassessment of the lease term, variable rents based on an index or rate, residual value guarantees, and the impact of purchase options.

The impact of the new standard will not be limited to external financial reporting. Internal reporting information, including financial budgets and forecasts, will also be affected.

In many cases, the total expense for operating leases under the new standard may be the same as under today's operating lease accounting. However, that may not always be the case. For example, prior rent expense may have included amortization

of deferred gains on qualified sale and leasebacks, which will now be recognized upon sale in a qualified sale and leaseback under the new standard.

Timely assessment of the new standard's impact on covenants and financing agreements will enable management to start discussions with banks, rating agencies, financial analysts and other users of the entity's financial data. Entities anticipating capital market transactions should consider the effects on their leverage ratios. Companies in the process of negotiating new or existing agreements should seek provisions in the agreements that specify how changes in GAAP impact financial covenants (i.e., whether covenant calculations are always based on then-current GAAP or on GAAP that was in effect when the agreements were signed).

## **Next steps**

Prior to adoption, management will need to catalogue existing leases and gather data about lease term, renewal options, and payments in order to measure the amounts to be included on balance sheet. Gathering and analyzing the information could take considerable time and effort, depending on the number of leases, the inception dates, and the availability of records. In many cases, original records may be difficult to find or may not be available. Other factors, like embedded leases, which had not been a focus before, will need to be identified and separately recorded.

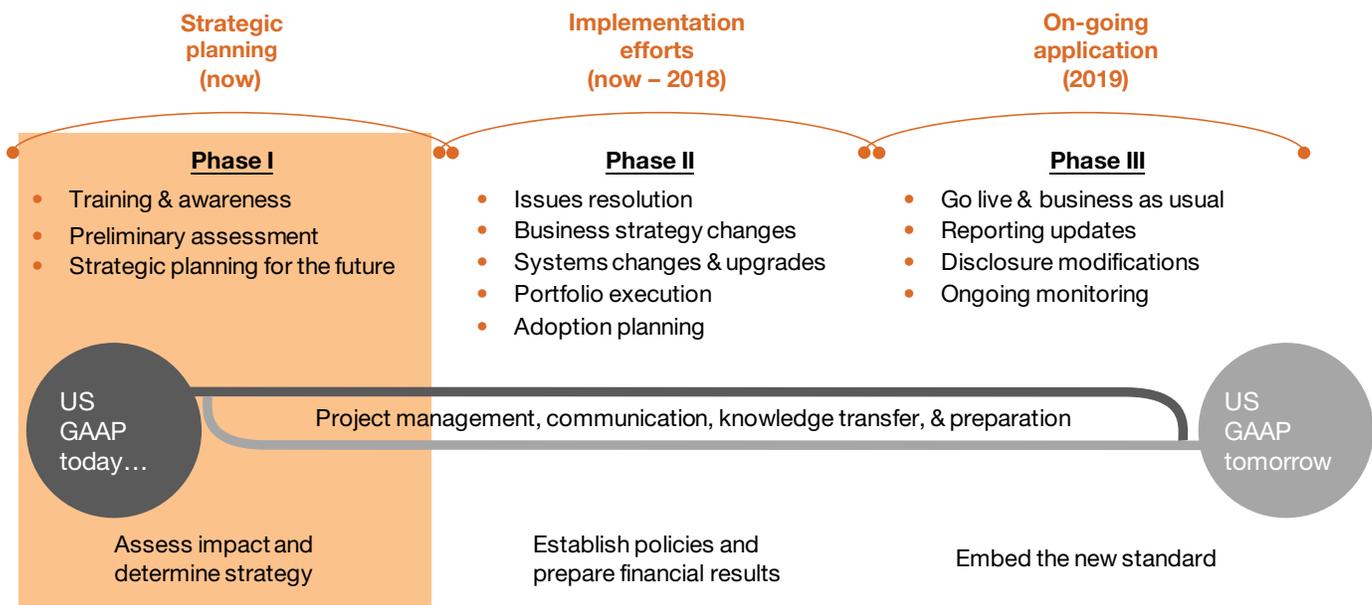
Given all of the above, these changes will necessitate potentially significant cultural changes as well as significant operational ones. While adoption of the new standard is not required for public business entities until 2019, organizations are well advised to begin considering the impact of these changes now, and to put into motion the steps needed to prepare the organization for the change. Under the modified retrospective transition approach, the 2019 financial statements will need to reflect adoption of the new standard as of January 1, 2017. In many cases, capturing data in real time may be more efficient than waiting until 2019.

Assuming adoption in 2019, the chart that follows depicts a potential transition plan with respect to evaluating the effects of the new lease model. Incremental corporate real estate strategy and systems changes would be performed concurrently with this plan.

The new standard will impact nearly every organization to some extent. As discussed in this document, the new standard will necessitate changes in the technical accounting, operational processes, and systems of many companies. We also believe that they may cause many to reconsider their overall corporate real estate strategy

in a more holistic fashion, which may assist in identifying how the corporate real estate role can become a strategic driver of operational success, thereby providing the “Catalyst for Change in Corporate Real Estate.” Beginning the process early will help ensure that implementation of the new standard is orderly and well controlled and that data from existing and new leases executed before implementation is captured from the outset. In addition, getting an early start may allow entities to consider potential adoption and negotiation strategy changes for new leases and the potential renegotiation of existing agreements in order to reduce the impact at adoption.

## Timeline



## *Preparing for the change*

- Educate affected individuals in all cross-functional areas about the new standard
- Create a cross functional "steering committee" to address the new standard and related transition
- Perform an inventory of your lease portfolio - understand what types of assets are leased and where the data resides
- Identify contracts likely to include embedded leases
- Consider modelling the transition impact on certain significant leases (or sample from a variety of lease types)
- Summarize existing systems and future needs
- Evaluate sufficiency of existing control processes and potential gaps
- Analyze potential income and other tax considerations (including federal, state, and foreign taxes)
- Identify contracts affected by the change in accounting (e.g., financial covenants, compensation agreements, earn-outs), the potential implications, and how terms should be modified in the future
- Identify regulatory issues affected by the change in accounting (e.g., regulatory capital implications and cost plus government contracts), the potential implications, and how terms should be modified in the future
- Consider potential changes in real estate leasing strategy (e.g., lease/buy, shorter vs. longer leases, modify common terms)

## *Key takeaways on transition*

- **Be strategic:** Planning your transition will go much more smoothly if you have concrete data. Modeling selected leases will give you relevant data to share with internal constituents. It will also help you understand what data you have, what data you need, and how your leasing strategy may need to change to minimize any potentially adverse accounting implications resulting from the new standard.
- **Manage market reaction:** For many significant users of real estate (e.g., retail companies), managing investor and other user expectation during the transition will be critical. Analysts and shareholders may soon raise questions about the potential impact. Longer term, the changes to presentation and the potential impact on financial metrics, will require thoughtful communication.
- **Don't wait:** In our discussions with clients, many expect adoption to take between 12 to 24 months – which doesn't give a lot of time to spare for a 2019 adoption. While the adoption timetable will vary by company, most believe adoption will be complex and time consuming. Targeted and measured steps today will help you understand the complexity and duration of the transition effort and more importantly, what steps you can take today to modify existing or planned leases to minimize the effort of complying with the new standard.

# How PwC can help

## **PwC's strengths – Our integrated approach**

Our industry specialists have extensive technical accounting and financial reporting, valuation, tax, operational, regulatory, strategy, and industry expertise. By bringing together these professionals, PwC can offer something that most firms do not: an integrated advice model.

We regularly advise members of the private and public sectors, owners, users, and investors in real estate. We serve organizations throughout the real estate industry, including corporate owners/users, developers, hospitality organizations, real estate investors and REITs.

PwC provides audit, tax, or advisory services to over half of the 50 largest private equity firms in the world and to over 40% of the REITs listed in the S&P 500 index. In addition to our presence throughout the United State, globally, PwC has established dedicated practices in leading non-US real estate markets, including Berlin, Hong Kong, London, Mumbai, Paris, San Paulo, and Tokyo.

In addition to serving the real estate investor/operators, we have provided real estate focused services to many of the largest retail, healthcare, hospitality, and other real estate users. These services include accounting, advisory, tax, systems, and strategy to

entities reconsidering their real estate usage and strategy as well as potential monetization strategies.

PwC has a global team of multidisciplinary professionals providing real estate services through all phases of the real estate lifecycle. We can help you understand not only the potential implications of the new lease standard, but also help you reconsider your overall real estate strategy.



**PwC has a global team of multidisciplinary professionals providing real estate services...**

## ...through all phases of the real estate lifecycle...

|                                | Strategic planning                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       | Deals                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            | Capital formation                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           | Business plan execution                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        | Exit                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
|--------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Considerations</b>          | <p>Are your real estate resources (time, talent, and money) properly allocated to generate value?</p> <p>Do you have a road map guiding your organization going forward and describing how it will get there?</p> <p>Are you prepared to navigate the obstacles and risks posed by organizational, financial, political, and stakeholder groups?</p>                                                                                                                                                                                                                                                                                     | <p>Have you validated the original assumptions of scope, risk, cost and approach in your real estate business case?</p> <p>Will you adjust these assumptions and the associated allocations?</p> <p>Does your internal team have capacity to deal with all phases of the due diligence process?</p>                                                                                                                                                                                                                                                                                                                                                                              | <p>Have you fully vetted the financial structure of a deal, including capital markets alternatives?</p> <p>Are the needs of all stakeholders being met without compromising commercially attractive and tax-efficient arrangements?</p> <p>Do you have the appropriate materials for each stakeholder group?</p>                                                                                                                                                                                                                                                                                                                                                            | <p>Do you have a proven methodology in place for effectively and efficiently executing complex business plans?</p> <p>Are you managing assets across the portfolio to improve utilization and performance, reduce capital costs, reduce asset-related operating costs, extend asset life and improve your return on assets?</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                | <p>When divesting assets or businesses, have you planned for capital markets and fair value guidance to realize optimal return on assets for greater reinvestment potential?</p>                                                                                                                                                                                                                                                                     |
| <b>Representative services</b> | <ul style="list-style-type: none"> <li>• Training, planning and implementation assistance with regard to new standard</li> <li>• Analysis of, or assistance with, evaluating financial and strategic impact of new standard</li> <li>• Market assessment / economic impact studies</li> <li>• Business case analysis</li> <li>• Equity market/story analysis</li> <li>• Sustainability strategy</li> <li>• Dispute avoidance strategy</li> <li>• IT and data strategy</li> <li>• Cybersecurity</li> <li>• Corporate real estate advisory</li> <li>• Merger or business acquisition considerations</li> <li>• REIT conversions</li> </ul> | <ul style="list-style-type: none"> <li>• Lease abstracting</li> <li>• Global fund, REIT, and investment tax structuring</li> <li>• Entity and corporate level financial due diligence</li> <li>• Cash flow modeling (ARGUS, DYNA, Excel) and model testing</li> <li>• Financial and tax entity-level due diligence</li> <li>• Cost segregation</li> <li>• Valuation for the purposes of business combinations</li> <li>• Capital markets advisory</li> <li>• Entity incorporations</li> <li>• Separation/stand-along cost analysis</li> <li>• HR/change management</li> <li>• Property due diligence services</li> <li>• Lease economic analysis and transfer pricing</li> </ul> | <ul style="list-style-type: none"> <li>• Deal structuring</li> <li>• Tax implications and structuring with respect to new standard</li> <li>• Sale-leaseback transactions</li> <li>• Loan underwriting/origination services</li> <li>• Investor level tax considerations</li> <li>• IPO readiness assessments</li> <li>• Performance measurement services/Track record verification</li> <li>• Tax considerations relating to General Partner compensation</li> <li>• IPO Advisory</li> <li>• Debt offering advisory</li> <li>• Global fund, REIT, and investment tax structuring</li> <li>• Valuation consulting</li> <li>• Financial modeling/model validation</li> </ul> | <ul style="list-style-type: none"> <li>• Complex accounting</li> <li>• Federal, state and international tax reporting/compliance</li> <li>• REIT testing/verification</li> <li>• Reorganization &amp; insolvency services</li> <li>• Asset monitoring &amp; asset management</li> <li>• Litigation &amp; arbitration</li> <li>• Risk &amp; regulatory work</li> <li>• IT and data architecture and integration</li> <li>• Process/control change consulting and implementation planning with respect to new standard</li> <li>• Operations outsourcing</li> <li>• Finance transformation</li> <li>• Capital markets services</li> <li>• Corporate secretarial</li> <li>• Evaluation/development of human capital and benefit programs</li> <li>• Evaluation/development of risk management programs</li> </ul> | <ul style="list-style-type: none"> <li>• Buy/sell side due diligence</li> <li>• Valuation</li> <li>• Disposition strategy</li> <li>• Accounting &amp; financial management</li> <li>• Tax deferred exchanges</li> <li>• Compliance, reporting and tax</li> <li>• Complex accounting</li> <li>• Building sustainability performance measurement</li> <li>• Merger integration</li> <li>• Global fund, REIT, and investment tax structuring</li> </ul> |
| <b>Benefits</b>                | <p>A better vision of your organization and its resources provides you with clearer expectations of your capabilities and overall business case.</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     | <p>What you don't know is always the most costly. By developing a careful understanding of the information at hand you are better positioned to negotiate and execute your transactions.</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     | <p>Having knowledge of and access to the capital markets before going to market allows you to accelerate the financing and deliver the best value for money to all your stakeholders.</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   | <p>Assistance with use or optimization of returns for real estate can proactively address risks before they occur.</p>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         | <p>Operational, financial, and risk management is critical throughout the real estate life cycle including exit.</p>                                                                                                                                                                                                                                                                                                                                 |

# Other PwC real estate publications

Our industry thought leadership publications provide up-to-date thinking about the regulatory landscape, evaluate emerging trends, and share ideas impacting the global real estate industry.



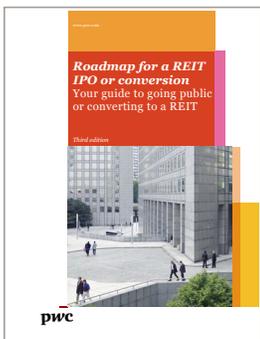
## **Unlocking shareholder value Real estate monetization strategies**

This paper contains an overview of real estate monetization strategies, their perceived risks and benefits, and how PwC can help companies evaluate factors associated with this approach.



## **Non-traditional REIT Transactions: An emerging trend**

This free-standing guide is focused exclusively on the unique issues and considerations that REIT transactions face.



## **Roadmap for a REIT IPO or conversion for traditional and non-traditional real estate companies**

These PwC guides are prepared to help both traditional and non-traditional real estate companies address the IPO and REIT conversion process.



## **Emerging Trends in Real Estate**

Based on personal interviews with and surveys from more than 1,000 of the most influential leaders in the real estate industry, this annual forecast will give you a heads-up on where to invest, which sectors and markets offer the best prospects, and trends in the capital markets that will affect real estate.



## **Real Estate 2020: Building the future**

As confidence returns to real estate, the industry faces a number of fundamental shifts that will shape its future. PwC has looked into the likely changes in the real estate landscape over the coming years and identified the key trends which, we believe, will have profound implications for real estate investment and development.



## **Cities of Opportunity 6**

This report analyzes the trajectory of 30 cities, all capitals of finance, commerce, and culture—and, through their current performance, seeks to open a window on what makes cities function best. We also investigate both the urbanization and demographic megatrends that shape our cities.



**US Real estate insights**

This quarterly publication provides our perspectives on the latest market and economic trends, regulatory activities and legislative changes affecting the real estate industry, as well as informed views of the most current developments in operations, business strategy, taxation, compliance and financing.



**PwC Real Estate Investor Survey**

The quarterly PwC Real Estate Investor Survey is widely recognized as an authoritative source for capitalization and discount rates, cash flow assumptions, and actual criteria of active investors, as well as property market information.



**PwC Hospitality Directions US**

This quarterly publication is a near-term outlook for the US lodging sector, commonly used by industry decision-makers and stakeholders to better understand the impact of policy and other macro-environmental factors on the sector’s operating performance.

**Where to find additional information:**

If you would like further information on the new lease standard or assistance in determining how it might affect your business, please speak to your PwC engagement partner or representative. Alternatively, a list of PwC contacts has been provided on the last page of this publication.

Also, refer to:

- **CFODirect**, which includes technical guidance on the new lease accounting standards
- **Adopting the new lease accounting standards**, for continually updated resources including updates on new developments to help you transition to the new leasing standards

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