www.pwc.com

The overhaul of lease accounting
Catalyst for change in corporate real estate

The IFRS edition

June 2016

Foreword

Byron Carlock
Partner
US Real Estate Leader
PwC US
+1 415 828 1998
byron.carlock.jr@us.pwc.com

Ilse French
Partner
EMEA Real Estate Platform Leader
PwC Luxembourg
+352 49 48 48 2010
ilse.french@lu.pwc.com

Active management of real estate assets is becoming a strategic imperative for users, and the newly established lease accounting standard is an incentive to reconsider real estate strategy.

Implementation of the new requirements may have a significant impact on companys' financial statements and require substantial changes to processes and systems.

Many companies, especially those that occupy significant real estate as part of their operations, are already reconsidering their real estate strategies due to changes in operating environments. In many cases, this reconsideration is part of an effort to align operational and real estate strategies but also to unlock shareholder value in existing assets or to provide growth capital for the continued expansion of capital-intensive industries. 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. As a result, most companies need a thorough real estate strategy that is aligned with overall corporate strategy. The benefits of adopting an integrated real estate strategy include improving workplace flexibility, sustainable occupancy cost management and allowing a rapid response to any change in the business environment.

When you are evaluating your real estate strategy, for whatever reason, PwC can help. We can guide you through the maze of new standards and their implications for your business, and help you as you consider their impact on your broader real estate strategy. PwC's global network of specialists with extensive knowledge of capital markets can also provide you with the insight you need to achieve increased organisational transparency for investors and shareholders. PwC offers a powerful combination of industry and real estate specialised experience and global reach that sets us apart and helps you achieve your goals.

Contents

Executive summary

In preparation for the new ***IFRS 16: Leases*** requirements, or to be more nimble in the current economic climate, C-suite at many companies with real estate dependencies are re-evaluating their corporate real estate strategy and operations to align with business objectives. 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.

The coming changes

The IASB and FASB have both recently issued new accounting standards that radically change 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 various models in different jurisdictions. This publication deals predominately with the application of the IASB model and its impact on entities reporting under IFRS.

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 and low-value assets)—existing and new—will be recognised on its balance sheet. The income statement treatment will be based on an approach similar to the current finance lease treatment in terms of ***IAS 17: Leases***. Companies need to apply this standard for annual reporting periods beginning on or after 1 January 2019, with some relief on transition under the practical expedient approach. Depending upon the transition approach applied, prior comparative periods will need to be restated. Early adoption is permitted, but only in conjunction with ***IFRS 15: Revenue from contracts with customers***.

Overview of the new leases standard

- The biggest changes were made to lessee accounting. Generally, IFRS 16 will apply to pre-existing leases at the date of initial application of the new standard. Lessor accounting is substantially the same under the new standard compared to ***IAS 17: Leases***.
- Essentially all assets leased under operating leases (except short term leases that are less than 12 months at lease commencement and low-value assets) will be brought on balance sheets. The lease liability will be equal to the present value of lease payments. A corresponding right-of-use asset will be recognised based on the lease liability plus items such as an estimate of restoration costs and initial direct costs.
- A lessee may decide as a practical expedient by class of underlying asset whether or not to separate lease and non-lease components (services).
- A lessee will recognise in its income statement, depreciation of the right-of-use asset and interest expenses arising from the lease liability.
- The accounting of certain arrangements will continue to require significant judgment, whether they are within the scope of ***IFRS 15: Revenue from contracts with customers*** or ***IFRS 16: Leases***.
- Lease accounting will require significant judgment when making estimates related to the lease term, lease payments, and the discount rate. Similar to today, the term of the lease will include the non-cancellable 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 lease payments are generally excluded when measuring the lease liability, except those based on an index or rate, which are initially included based on the index or rate at lease commencement. IFRS 16 requires reassessment of variable lease payments that depend on an index or a rate when there is a change in the cash flows resulting from a change in the reference index or rate (that is, when an adjustment to the lease payments takes effect). This can result in a significant amount of periodic remeasurement and income statement volatility. The new guidance will require reassessment of the lease and remeasurement of the lease liability under certain circumstances. This is substantially different than today's "set it and forget it" model.
- When calculating present value, the applicable discount rate will be determined in a similar manner to IAS 17.
- A lease modification may be accounted for by the lessee as a modification to the original lease or as the creation of a separate lease depending on the nature of the modification. A lessor would account for modifications to an operating lease as a new lease and modifications to a finance lease generally as a separate lease or new lease depending on the nature of the modification.
- 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 US GAAP as there are significant differences between the IFRS and US GAAP standards.

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.

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 monetising 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 recognise 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**. Application of the new standard may have a substantial impact on income-based performance metrics, and it may also impact other financial metrics that utilise 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 have tax implications, 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 and low-value assets, 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**. The standard requires one of two approaches to be applied on transition: a full retrospective approach (including restatement of all comparative periods), or a simplified approach which requires the lease liability and the right of use asset to be recognised at the beginning of the annual reporting period in which the entity first applies IFRS 16 as an adjustment to retained earnings and no restatement of comparative information.

Opportunity

The last several years have seen a host of changes facing corporate real estate organisations. 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 organisation has often been overlooked or has not kept pace with the changes in the rest of the organisation 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 organisation.

As asset values increase, companies are re-evaluating capital committed to real estate, focussing on maximising returns on investment. 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 make it an ideal time to reconsider whether your organisation 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 your 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 the current market opportunities (e.g., lease rates/purchase prices) and how would they affect your real estate strategy?
- How do 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, as represented below.

The impact on 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

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 is 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 often consist of 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 borrowing 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 centres, 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 monetisation trends, most prominent in the U.S., which are having the effect of driving real estate assets off corporate real estate user's balance sheets.

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 stabilising, 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 favourable 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 monetisation trends. Companies may, in fact, want to sell a property subject to a long-term lease back at a high valuation and effectively monetise 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

Tax considerations often play 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 utilise 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 many cases, taxes will remain unchanged; however, significant deferred tax adjustments may need to be tracked as the related book amounts change. This may vary significantly according to jurisdiction.

There also may be other types of tax issues associated with the new standard, such as stamp duties and other transfer tax or property tax consequences. Companies may need to evaluate the unique tax provisions found in each locality to determine the various consequences to their particular case due to the new leasing standard.

Internationally, the new lease accounting model may have other impacts on the tax treatment of leasing transactions. In many jurisdictions, tax accounting for leasing is often based on accounting used for book purposes. 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 optimise the tax position by enabling entities to seek possible opportunities and/or reduce tax exposures.

Regulatory issues

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/insurance companies 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 centres, and automated teller machine 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 corporate real estate users utilise 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. 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 subsidiary's books, which have a number of impacts. 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 alternatives

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, what had previously been 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 utilised for a substantial portion of their lives—instead of paying much higher implicit rates in leases would be adding 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 the corporate real estate function in an organisation

In many organisations today, the corporate real estate department is viewed as more of an administrative function or "cost centre" 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 decentralised 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 centralised 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) minimise 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 utilised 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 labour-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 FASB issued its new lease accounting standard on 25 February 2016 with a similar adoption date. While current lease accounting by lessees was largely aligned under current rules, the FASB's new standard creates some significant points of additional divergence from IFRS. Most notably, while both standards put leases on balance sheet, the FASB adopted a dual model for income statement purposes. Accordingly, multi-national companies may need to track both models if they have to report under IFRS for consolidated financial statements and then US GAAP for statutory 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 recognised 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.

The new lease model will change both balance sheet and income statement presentation. Leverage and capital ratios may suffer from the gross-up of balance sheets.

Under IFRS 16, the rent expense previously recognised for operating leases under IAS 17 will be replaced by interest and depreciation. In addition, the expense recognition pattern may change significantly. This will negatively influence some performance measures, such as interest coverage ratios, but conversely improve others, such as EBIT/EBITDA and cash flow from operations, all with no change in the underlying cash flows or business activity. In addition, continuous remeasurement may increase volatility in these ratios. These ratios may no longer be useful for their historical purpose and other operating metrics may evolve as a result of the adoption of 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 IFRS impact financial covenants (i.e., whether covenant calculations are always based on then-current IFRS or on IFRS that was in effect when the agreements were signed).

Next steps

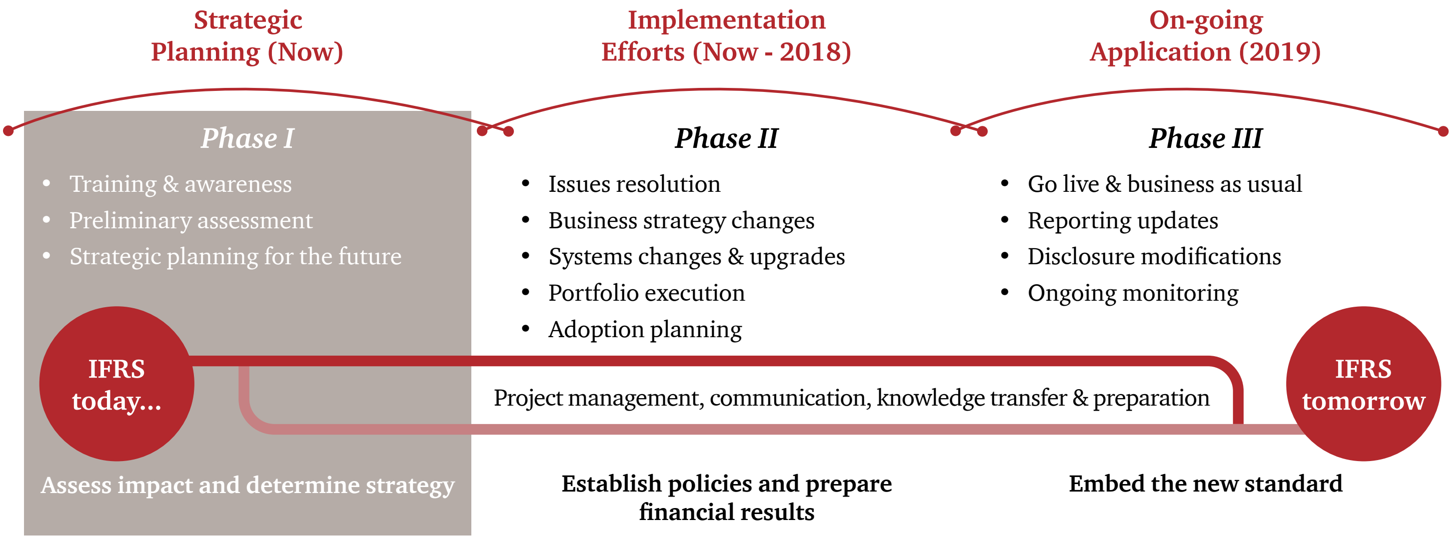
Prior to adoption, management will need to catalogue existing leases and gather data about lease term, renewal options, and payments in order to measure the amounts to be included on balance sheet. Gathering and analysing the information could take considerable time and effort, depending on the number 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 entities reporting under IFRS until 2019, organisations are well advised to begin considering the impact of these changes now, and to put into motion the steps needed to prepare the organisation for the change.

Assuming adoption in 2019, the chart below 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 organisation 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)
- ❑ Summarise existing systems and future needs
- ❑ Evaluate sufficiency of existing control processes and potential gaps
- ❑ Analyse potential income and other tax considerations (including deferred taxes for each jurisdiction)
- ❑ 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. Modelling 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 minimise 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 minimise the effort of complying with the new standard.

How PwC can help

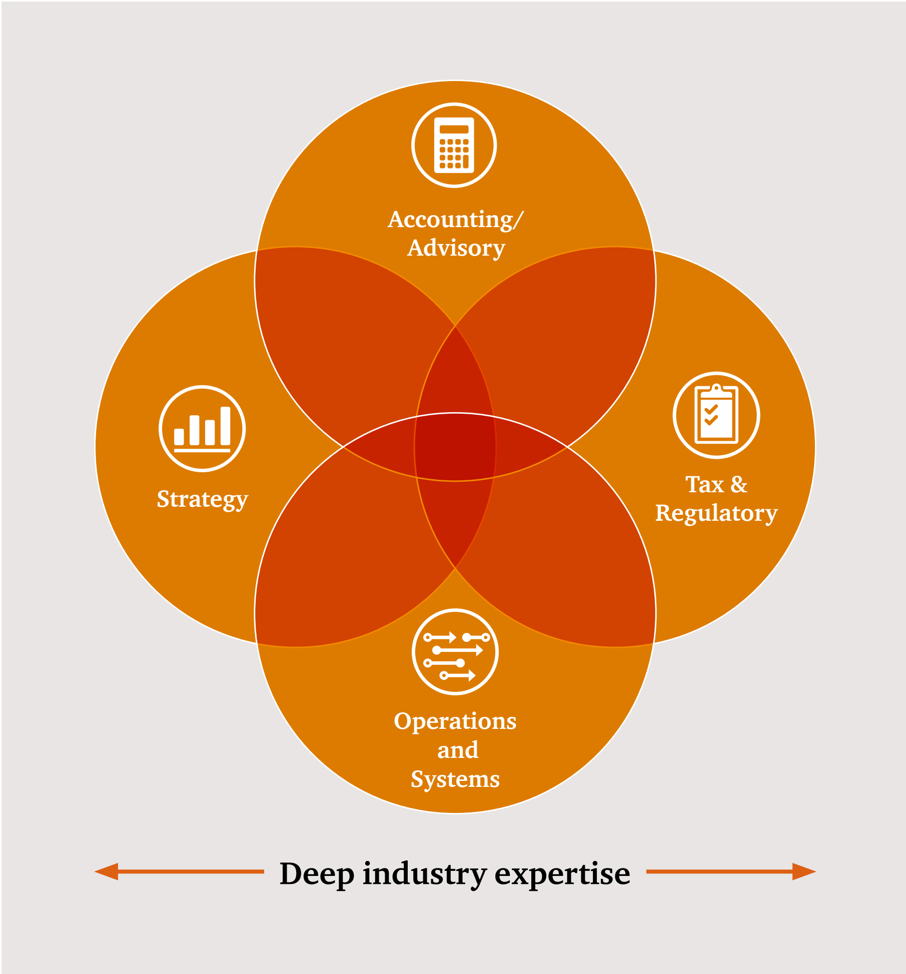
PwC's strengths - Our integrated approach

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 organisations throughout the real estate industry, including corporate owners/users, developers, hospitality organisations, real estate investors and REITs.

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 monetisation strategies.

PwC has a global team of multidisciplinary professionals providing real estate services through all phases of the real estate life cycle. 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 multi-disciplinary teams of specialists who can assist you with all aspects of your corporate real estate decisions.

Real estate strategy and accounting advisory

- Training, planning and implementation assistance with regard to new lease standard
- Analysis of needs and market trends
- Analysis of, or assistance with, evaluating financial and strategic impact of new lease project

Tax and transaction support

- Analysis of tax implications and structuring opportunities with respect to new lease standard
- Sale-leaseback transactions
- REIT spin-offs of corporate real estate to unlock shareholder value
- Tax planning transactions systems and processes

Systems and processes

- Process/control change consulting/implementation planning with respect to impact of new lease project
- Strategic information systems planning
- Gap analysis & system selection
- Technology integration & implementation

Operational effectiveness and cost containment

- Process re-design & leading practices in corporate real estate
- Benchmarking and performance monitoring
- Spend analysis, strategic sourcing, outsourcing effectiveness
- Operational and organisational effectiveness
- Lease expense "audits" for potential recovery

Valuation/market analysis

- Real estate and lease portfolio valuation
- Market studies
- Valuation analyses in conjunction with accounting requirements

Deals services

- Deal origination
- Due diligence and valuations
- Post-deal support

Occupier advice

- Real Estate strategy
- Real Estate and facilities management functional design
- Real Estate and facilities management outsourcing
- Cost reduction
- Capital programme and management reviews

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. Alternatively, a list of PwC contacts has been provided p.20.

Contacts

If you are interested in discussing any of the points raised in this publication or general Real Estate topics in more detail, then please contact us:

Connecting the PwC Real Estate Platform

Byron Carlock
Partner
US Real Estate Leader
PwC US
+1 415 828 1998
byron.carlock.jr@us.pwc.com

William Croteau
Partner
PwC US
+1 214 754 7904
william.croteau@us.pwc.com

Ilse French
Partner
PwC Luxembourg
+352 49 48 48 2010
ilse.french@lu.pwc.com

Real Estate country contacts

Frank Magliocco
Partner
PwC Canada
+1 416 2284 228
frank.magliocco@ca.pwc.com

Geoffroy Schmitt
Partner
PwC France
+33 1 5657 5482
geoffroy.schmitt@fr.pwc.com

Susanne Eickermann-Riepe
Partner
PwC Germany
+49 69 9585 5905
susanne.eickermann-riepe@de.pwc.com

Kwok Kay So
Partner
PwC Hong Kong
+852 2289 3789
kk.so@hk.pwc.com

Amaury Evrard
Partner
PwC Luxembourg
+352 621 332 106
amaury.evrard@lu.pwc.com

Jeroen Elink Schuurman
Partner
PwC Netherlands
+31 88 792 6428
jeroen.elink.schuurman@nl.pwc.com

Alsue du Preez
Partner
PwC South Africa
+27 11 797 5609
alsue.du.preez@za.pwc.com

Guillermo Masso Lopez
Partner
PwC Spain
+34 91 568 4353
guillermo.masso.lopez@es.pwc.com

Craig Hughes
Partner
Global Real Estate Leader
PwC UK
+44 20 7212 4183
craig.hughes@uk.pwc.com

Capital Markets Accounting Advisory Services

Dora Cheung
Partner
PwC Beijing
+86 10 6533 7070
dora.cheung@cn.pwc.com

Philippe Kubisa
Partner
PwC France
+33 1 56 57 80 32
philippe.kubisa@fr.pwc.com

Andrea Bardens
Partner
PwC Germany
+49 69 9585 1196
andrea.bardens@de.pwc.com

Simon TW Cheng
Partner
PwC Hong Kong
+852 2289 1522
simon.tw.cheng@hk.pwc.com

Marc Minet
Partner
PwC Luxembourg
+49 48 48 2120
marc.minet@lu.pwc.com

Jay Tahtah
Partner
PwC Netherlands
+31 88 792 39 45
jay.tahtah@nl.pwc.com

Chen Voon Hoe
Partner
PwC Singapore
+65 6236 7488
voon.hoe.chen@sg.pwc.com

Zubair Wadee
Partner
PwC South Africa
+27 11 797 5875
zubair.wadee@za.pwc.com

Rocio Fernandez Funcia
Partner
PwC Spain
+34 915 685 052
rocio.fernandez@es.pwc.com

Kirsty Ward
Partner
PwC UK
+44 20 7804 2999
kirsty.a.ward@uk.pwc.com

Tom Wilkin
Partner
PwC US
+1 646 471 7090
tom.wilkin@us.pwc.com

Notes

www.pwc.com

Follow us

At PwC, our purpose is to build trust in society and solve important problems. We're a network of firms in 157 countries with more than 208,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com.