IFRS lease accounting impact on Corporate Real Estate Management

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15 April 2013
IFRS lease accounting impact on corporate real estate management II
Master thesis: IFRS lease accounting impact on Corporate Real Estate Management
Date: 15/04/2013

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IFRS lease accounting impact on Corporate Real Estate Management IV
Preface

This thesis is the final product for our graduation project of the master track Real Estate Management & Development at the Eindhoven University of Technology. For this graduation project we had the opportunity to be among the first to conduct research into both the worlds of accountancy and corporate real estate, which is not common practice to study at a technical university and therefore very interesting. We were able to study these subjects with the support of the TU/e, Deloitte and REDEPT.

These are very interesting and uncertain times for publicly traded companies; legislations are changing due to the economic and financial turmoil. Stakeholders will ask new questions and thus will companies have to scrutinise their strategies and decision-making processes regarding their organisation and their corporate real estate, to be able to deal with these developments. This implies that CREM divisions will have, to a greater or lesser extent, to deal with the consequences of these changes.

No empirical evidence is available for the wanted or the unwanted impacts and consequences because most of these proposed changes will become effective the years ahead and have not yet been studied. Few studies, therefore, address the impact of IFRS lease accounting on corporate real estate management and their findings are often general and differ from each other. This thesis therefore tries to shed some light on these subjects and analyses and structures the (future) developments and (future) problems. This thesis also shows new insights into the impact of an accounting rule on corporate real estate management and provides tools to manage these implications.

We would like to thank Rianne Appel-Meulenbroek and Berend van Egmond for their helpful comments and continuous support as our supervisors from the Eindhoven University of Technology. We are also very grateful to our supervisors at Deloitte, especially Mathijs Hesselink, and Kees Zachariasse, and at REDEPT, especially Leon van Leersum and Paul Stotesbury for their comments and practical support. Furthermore, we would like to thank all the experts who participated in the interviews and surveys, which provided valuable input for this thesis. As a last remark, we would like to thank our family, our girlfriends and our close friends for their support and faith in us.

Sjuul Baltussen & Tim Schelle

Monday, 15 April 2013
Executive summary

CREM - “The management of a corporation’s real estate portfolio by aligning the portfolio and services to the needs of the core business (processes), in order to obtain maximum added value for the businesses and to contribute optimally to the overall performance of the corporation.” (Krumm, Dewulf & De Jonge, 2000, p. 32) has grown as a professional discipline over the past decades. At almost every organisation, CRE practices have evolved from a narrow definition focusing on managing real estate transactions, design, and construction projects, to managing a wide range of functions that support internal and external business factors (Varcoe & O’Mara, 2011).

The current global financial and economic crisis strengthened the widespread calls for changes in the regulatory system due to numerous financial scandals at inter alia, Enron in 2001, WorldCom, Xerox, Sunbeam, Waste Management, Adelphia, Tyco, HealthSouth, Global Crossing in the U.S. (Coates, 2007) and, for example, Ahold in the Netherlands. These scandals were the motivation for the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) that leases should be considered as an important source of financing. As a result the IASB and FASB started a much debated project to develop a global financial reporting system in 2006, including reporting for leases, which would have to prevent these major ‘Enron-like’ scandals. To address these problems, the lease accounting proposal suggests a completely new model for lease accounting. Transparency and comparability for the users of financial statements is key in this project.

The IASB and the FASB have proposed to remove the current difference between finance leases (off-balance) and operating leases (on-balance). This means that essentially all assets currently leased under operating leases will be brought on-balance, most likely from 2017 onwards. While in the past, leasing meant that the use of assets would only run as costs through the annual profit and loss accounts, companies around the world awake in a future in which leases will appear much more prominently in their corporate financial statements. The lease contract will be recognised both at the asset side as a Right of Use (ROU) asset and the present value (PV) of payments to be made over the lease term is recognised as the lease liability on liability side of the balance sheet. In other words, real estate use –both rented and owned– will appear explicitly in the financial statements of companies. This should significantly improve the transparency and comparability concerning the CRE exposures and CRE debt obligations of the addressed organisations. These tentative changes to current lease accounting are mandatory for all users of IFRS and have, because it is an accounting regulation, its effects on the accounting profession. However, the majority of these of ‘off-balance’ leases can be related to CRE leases whereupon the consequences are not limited to the accounting profession. As a result, major changes may occur with the changing way of preparing the financial statements. This change in accounting standards will automatically shift the way in which corporations communicate about their CREM. While in the past information on CREM was often opaque and incidental, now an era is entered in which the financial reporting will ensure that the numbers appear more often and more prominently. In figure I a matrix of this CREM communication is illustrated.

![Figure I: CREM communication](source: Adaption of Brounen, Verschoor, & Würdermann (2012))
Information is considered opaque when the numbers are scarce and appear only in technical notes, while information is transparent when numbers are presented notably in combination with a clear discussion of CRE strategy and vision. Companies that are in the denial phase (I) tend to communicate only the bare necessities, as it is hard to talk about matters that one ignores. It may even be claimed that IFRS lease accounting will catapult CREM communication automatically into the acceptance phase (V). The information regarding a company’s real estate use and costs will become much more transparent and appear continuously in all corporate financial statements. This could raise new questions for CREM divisions about their CRE portfolios. Past research showed that accounting is a potential variable in CRE decision-making, however, no study before, as far it is known, distinguished neither between the possible impact of IFRS lease accounting on CRE strategies and the relating CRE operating decisions nor provided insight into how to cope with these possible implications. This resulted in the research objective for this thesis:

“The primary research objective is to model the potential impact of the lease accounting changes on the CRE strategies and potential implementation problems for the CRE decision-making processes, in order to develop an understanding of the role of accountancy in the strategic decision-making processes of CREM divisions and to, subsequently, provide tools to manage these possible impacts.”

Which has been translated into the following research question for this thesis:

“What impact do lease accounting changes have on corporate real estate strategies, and what are the consequences for future corporate real estate portfolio decisions?”

Companies that make use of IFRS will need, thus, to be able to recognise the amount of CRE they use, own and rent, and motivate the decisions that have been made. Therefore, CRE strategies and operating decisions of AEX publicly traded corporations that have other core businesses than real estate, are scrutinised, since they are all users of IFRS guidance because they are publicly traded.

Strategies are formed within an organisational and environmental context. Changes within this context might impact the strategy formulation or could be a reason to reassess the strategy policy. Since IFRS lease accounting affects the environmental context, by changing the legal environment, CRE strategies could indirectly be affected by new regulatory issues towards leasing. In addition, strategies are implemented in order to ensure the corporations’ continuity and for AEX listed companies in particular- to maximise shareholders value. To be able to maximise shareholders value, it is essential for CRE strategies to be fully aligned with the corporate business strategy. This alignment is classified according to the five stages of the Joroff-model. This is illustrated in figure II per AEX listed company.

![Figure II: Joroff-model](source: Adaption of Mattousch (2010))
The CREM contribution depends on the stage of CREM on the Joroff-model and competitive advantage is only realised when CREM operates at strategic level and is, thus, fully aligned with the overall corporate strategy. However, not all CRE strategies are prone to financial changes. Therefore, CRE strategies are classified. CREM literature describes seven alternative CRE strategies that can be related to the corporate strategies of Porter (1985) and divided in ‘Exchange’ and ‘Added use’ value strategies. The Exchange value strategies (reducing costs, increasing the value of the asset and increasing flexibility) have a direct financial impact on the corporate performance and are therefore directly exposed to financial accounting regulations like IFRS lease accounting. The performance of Added use value strategies are not in full control of the CREM, since it depends on the relation and interaction with other corporate resources. Strategies are evaluated and reassessed by internal performance measurements. For CREM departments that act lower than the strategist level these performance indicators are in general financially driven by their added value in terms of profitability and productivity. These financial performance indicators are subsequently exposed to the new IFRS regulations. If these performance indicators change significantly this could result in adaption of the strategy in order to meet the internal performance goals. Figure III summarises where IFRS regulations influence the (CRE) strategy process.

Notwithstanding, the impact should not be underestimated. Accounting regulations would probably have no impact on CRE strategies that are strongly strategically driven and thus belong to the ‘Strategist’ stage of the Joroff-model. However, for those CREM divisions that are not participating on this ‘Strategist’ level and make use of (part of) an Exchange use strategy, new regulatory issues could form a bottleneck since the lack of strategic motives and their review is solely based on financial performance indicators. For those divisions could lease accounting be a catalyst for revision of the CRE strategy and may result in an evolution on the Joroff-model.

What about operating decisions? The tentative decisions made by the IASB and FASB prescribe that current and future CRE leases have to be recognised on-balance. When CREM divisions are lacking an explicit CRE strategy that is consistent with the business strategy than they may exercise operating decisions that are unrelated to or even in conflict with the corporate business strategy rather than being consistent with their real estate strategy. This situation could cause organisations that rely heavily on financial components and own large CRE portfolios to make changes to their data management, transaction management and/or portfolio decisions, all with respect to CRE.

The lease accounting proposal stipulates that all operating leases should be capitalised using the present value of expected lease payments. Therefore, CRE managers will first need to catalogue existing leases and gather –the correct- data about all ten management buttons; the number of assets, the locations, the financing arrangements, the lease terms, renewal options, purchase options, base rents, subleases, service contracts and discount rates to measure the amounts to be included on balance sheet. Gathering and
analysing the information could take considerable time and effort, considering the number of leases that have been taken up years ago at numerous decentralised locations, the commencement dates and the records available. Furthermore, the impact of the change will not be restricted to external reporting; internal reporting information, including financial budgets and forecasts, will also be affected. This could imply that the relationship between the corporate Chief Financial Officer (CFO) and CRE managers will have to change, because every time a lease occurs the balance sheet will be impacted. Thereby, the proposed lease accounting guidance requires recognising the use of real estate –both leased and owned– explicitly in the financial statements of corporations. This shift will greatly improve the visibility of CRE stakes and costs. This will have an impact on balance sheet ratios in the first few years and thereby raise questions among shareholders.

The proposed lease accounting changes can cause transaction processes to be more time consuming because the reassessment of changes in lease contracts could become a tug of war between lessees and lessors. Most evident is the fact that the lessee would have to use a discount rate to calculate the PV of the leased asset. As chapter 2 discussed the lessee would use the rate the lessor charges the lessee when that rate is available; otherwise, the lessee would use its incremental borrowing rate (i.e. the specified WACC). This, thus, means that one can ‘negotiate’ to a certain extent the discount rate the lessee will have to use because lessors will not release their yields without a struggle. Furthermore, it will first be necessary to determine whether specific elements of a lease can be viewed as separate components with future negotiations, since service contracts do not have to be capitalised.

The advantage of improving performance measures by clearing the corporate balance sheets with off-balance sheet accounting disappears. This fact results in reconsidering the financing arrangement (‘lease versus buy decision’), long-term versus short-term lease decisions and floating versus fixed rate contracts. For example, an increased attractiveness of ownership compared with long-term leasing may be expected because ownership will become relatively more attractive and lease terms would be shortened because the ratios used by the investor and lender can be considerably affected by the grossed-up balance sheet. To minimise consequences, CRE may be directed to entering into shorter lease-terms. Furthermore, in transactions such as SLBs it is the case that the desire to achieve operating lease treatment has influenced transaction structuring and thus has impacted decision making but probably not the actual decision to undertake the transaction.

Companies have many options when it comes to how to deal with their CREM. On the one hand, they need to decide how to set up their real estate needs, and on the other hand they need to decide on how to communicate these decisions. The first will be very company specific. Clearly, for corporations that face very special CRE needs it will not be easy to find a lease alternative for building up ownership. For other companies, that are more reliant on standardised office space, leasing may be an interesting option. In all cases, it is important to make the decisions in line with the overall corporate objectives. Assuming that this relates to maximising shareholder value, one needs to be able to explain to stakeholders how the CREM will affect the KPIs. On the part of how to communicate CREM policy, corporations experience a future in which they are forced to ‘speak out’. Decision-making processes concerning portfolio strategy and portfolio management will, thus, be far more complex, especially when the corporate CREM division does not operate on the ‘Strategist’ stage of the Joroff-model. These changes to the trichotomy; data management, transaction management, and portfolio management can be managed according to the provided ten management buttons, illustrated in figure IV.

<table>
<thead>
<tr>
<th>Financing arrangement</th>
<th>Number of assets</th>
<th>Discount rate</th>
<th>Purchase option</th>
<th>Subleases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease term</td>
<td>Service contracts</td>
<td>Renewal options</td>
<td>Rent</td>
<td>Location</td>
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Figure IV: Ten important management buttons
To what extent these ten buttons should be altered is a question that should be answered for every real estate transaction a CREM division is intending to make and of course in the context of the real estate strategy. However, this altering of these management buttons is most likely to be executed with the ‘fluid’ assets of the CRE portfolio.

To be able to quantify the impact for each corporation within the sample, an extensive analysis is conducted to determine what the total impact of IFRS lease accounting will be on key performance indicators, balance sheet and income statement presentation according to the Imhoff, Lipe, and Wright (1991) method. This macro analysis claims not to represent the actual impact, but the gives a good insight into the relative impact.

Prior to the actual analysis two observations where striking; in contradiction to previous studies, the amount of real estate and land on AEX listed companies’ balance sheets seems to be much lower (7%) than expected (figure V). This might be caused by the method that is used for determining the value, book value versus market value. Notwithstanding this is still a remarkable difference compared to previous findings. In addition, 74% of the lease portfolio consists of operational leases (figure VI). Irrespectively whether these leases are knowingly structured as operational lease or not, the IASB is right in saying that it is hard to justify that presenting just 26% of the total lease liabilities on the corporate balance sheet presentations of the AEX is transparent.

In first instance, the CRE related impact seems to be significant, especially for corporations with a high retail lease exposure like Ahold. Also corporations with a large exposure to leases related aircrafts and freighters e.g. AirFrance-KLM, Fugro and TNT are subjected to the magnitude of IFRS lease accounting. For these corporations the impact is due to their business model. These findings correspond to previous studies in the U.S., Germany and Spain. Subsequently, the analysis illustrates that the relative impact of the proposed lease accounting changes is less severe than was expected and emphasised that the greater part can be traced back to CRE leases. Due to the different business models and industries it is hard to compare the 23 corporations with each other, which is directly the limitation of this study. It would be more realistic to compare corporations within a specific industry.

![Figure V: Ratio property versus land](image1.png)

![Figure VI: Ratio finance versus operational leases](image2.png)

![Table I: Median impact](image3.png)
Although the impact seems to be smaller than expected (table I) it should not be underestimated. IFRS lease accounting affects the key financial ratios. Since these ratios play an important part in the decision-making of internal reviews, lenders, rating agencies and shareholders, corporations tend to mitigate the impact as much as possible. Especially corporations that endure more impact than comparable corporations within the industry could expect additional questions from stakeholders.

A serious consequence of the lease accounting implementation is the compliance issues with debt covenants, especially when due no transparent or incomplete disclosures additional information comes to the horizon. It is before renegotiation essential to understand what and why companies have a particular lease portfolio, predict what the impact will be and prepare to reduce the impact if necessary. Since the greater part of the impact is related to CRE leases this are also the leases wherewith the impact the most could be influenced. It would therefore not be unthinkable that corporations will use the ten management buttons in order to mitigate the impact. Especially for corporations with stressed financial positions, the management buttons are a welcome tool for corporate executives to reduce the impact of IFRS lease accounting.

What is the market expecting?
During the interview period, certain common opinions were observed from the interviewees. Among the most important was the idea that this proposed accounting guidance would require a new level of detailed information because every lease, no matter the size or length, would need to be accounted for and scrutinised over its term. Several companies, that have already begun the implementation process, admitted to realising that their current information systems lack detailed lease information. Therefore, managing an entire portfolio of complex leases would prove to be extremely challenging. Some companies mentioned specific lease tracking systems, of which certain components had already been installed, which provided companies with a level of understanding far beyond that which had previously been available. Assuming virtually every public company with the need for this data would incorporate systems like this, the result would create clarity, and possibly even efficiency throughout the industry, as companies would become more aware of the space they occupy versus their actual space requirements. Consequentially, companies will be forced to look critically at their real estate strategies. Determining the real estate strategy will involve many elements. However, when all else is equal, the proposed lease accounting changes may be a catalyst to implementing change.

A good understanding of its resources is a critical ingredient for a successful strategy. Such knowledge creates confidence among business units who are then more willing to cooperate and depend upon the CREM division to make value-adding decisions. It also ensures that CREM can communicate its contribution to the company in a language that the top decision makers understand. This ‘language’ will get far more important when, as argued, the relationship between the CRE executive and the CFO will change due to the proposed IFRS lease accounting rules. As a result, CRE will attract more attention and new questions about CRE and its strategy will be asked. CRE managers will, thus, have the potential to shape future successes for organisations. Furthermore, the transparency and structure of the proposed IFRS lease accounting rules, provides the opportunity for CREM divisions to revise their CRE strategy and operating decisions to be able to reach the ‘Strategist’ stage on the Joroff-model.

So what is the impact of the proposed lease accounting changes?
In general, it can be concluded that the impact for a particular company would be largely based on three main factors or a combination of both: 1) the place of the company on the Joroff-model, 2) the size of a company’s operating lease portfolio relative to its balance sheet and 3) a company’s sensitivity, due to their CRE strategy, to financial statement presentation. It has been demonstrated that changing regulatory issues are not just compliance issues for all organisations but can be a catalyst for corporations to change their decision-making processes. These factors make a company more likely to change their behaviour to mitigate the effects of the proposed changes. As a result, CRE will attract more attention and new questions about CRE use and its strategy will be asked. Logically but far from common practice for CREM is first to understand what CRE related assets and liabilities they possess.
and why they have them according to the proposed Real Estate Lease (REL) benchmark. Second, they should predict and model what the potential impact could be. And last but not least corporations are able to prepare for the transition and mitigate the impact with the ten management buttons that are provided. Providing transparency in an early stage with all stakeholders is thereby crucial because future financial statements will leave little space to manoeuvre as both rental and ownership will become balance sheets items that need to be recognised and scrutinised. This is not a problem, if companies get prepared. CREM divisions have, thus, more than ever before the potential to shape future successes for organisations.

**No one-fits-all solution**

Development of a strategic plan with the associated operating decisions and a performance measurement system as outlined below provides the CRE manager with a framework that is easily explainable and defensible to the top level decision makers in the company. Thus, CRE management can move more squarely into the strategic planning process and live up to its potential to add value to the company. See figure VII for a schematic overview of the steps that companies will have to continuously go through.

![Image: Management support tool](image_url)
# Table of contents

Preface ........................................................................................................ V
Executive summary .................................................................................... VII
Table of contents ......................................................................................... XVI
List of abbreviations ................................................................................... XIX
Defined terms ............................................................................................. XX

## 1 Introduction ............................................................................................. 1

1.1 Motivation ......................................................................................... 1
1.2 Problem outline & definition ......................................................... 3
1.2.1 Problem outline ........................................................................ 3
1.2.2 Problem definition .................................................................... 4
1.3 Research objective and questions .............................................. 4
1.3.1 Research objective .................................................................. 4
1.3.2 Research questions .................................................................. 4
1.4 Demarcation ...................................................................................... 5
1.5 Research relevance .......................................................................... 6
1.6 Research design ................................................................................ 7
1.7 Research outline ............................................................................... 8

## 2 Lease accounting .................................................................................. 11

2.1 Overview and background .............................................................. 11
2.1.1 Financial reporting: two flavours ......................................... 11
2.1.2 Accounting for leases today .................................................. 12
2.1.3 History of the lease accounting project .................................. 17
2.2 The future of lease accounting ...................................................... 19
2.2.1 Key changes for lessee accounting ....................................... 19
2.2.2 A corporate real estate lease example .................................. 23
2.2.3 Impact of lease capitalisation on corporate KPIs ..................... 24
2.3 CREM implications ......................................................................... 26
2.4 Effective date: No time to waste ............................................... 32
2.5 Conclusion ....................................................................................... 33

## 3 Corporate real estate strategy ............................................................... 37

3.1 Strategy ............................................................................................. 37
3.1.1 Strategy context ....................................................................... 40
3.2 Corporate real estate strategies ...................................................... 40
3.3 Managing the fifth resource ......................................................... 44
3.3.1 The evolution of corporate real estate management ............... 46
3.4 Performance indicators of CRE ..................................................... 49
3.5 Conclusion ....................................................................................... 53

## 4 Corporate real estate decision-making .................................................. 57

4.1 Portfolio decision-making ............................................................. 57
4.1.1 Operating decisions ............................................................... 58
## List of abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>AFM</td>
<td>Autoriteit Financiële Markten (Dutch SEC)</td>
</tr>
<tr>
<td>AIFMD</td>
<td>Alternative Investment Fund Managers Directive</td>
</tr>
<tr>
<td>CFO</td>
<td>Chief Financial Officer</td>
</tr>
<tr>
<td>CHRO</td>
<td>Chief Human Resources Officer</td>
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<tr>
<td>COO</td>
<td>Chief Operating Officer</td>
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<tr>
<td>CPO</td>
<td>Chief Procurement Officer</td>
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<tr>
<td>CRE</td>
<td>Corporate Real Estate</td>
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<tr>
<td>CREM</td>
<td>Corporate Real Estate Management</td>
</tr>
<tr>
<td>CTL</td>
<td>Credit Tenant Lease</td>
</tr>
<tr>
<td>DCF</td>
<td>Discounted Cash Flow</td>
</tr>
<tr>
<td>EBIT</td>
<td>Earnings Before Interest and Tax</td>
</tr>
<tr>
<td>EBITDA</td>
<td>Earnings Before Interest Tax Depreciations and Amortisation</td>
</tr>
<tr>
<td>ED</td>
<td>Exposure Draft</td>
</tr>
<tr>
<td>EMIR</td>
<td>European Market Infrastructure Regulation</td>
</tr>
<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board (U.S.)</td>
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<tr>
<td>FM</td>
<td>Facility Management</td>
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<tr>
<td>I&amp;A</td>
<td>Interest &amp; Amortisation</td>
</tr>
<tr>
<td>IAS</td>
<td>International Accounting Standards</td>
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<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
</tr>
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<td>IASC</td>
<td>International Accounting Standards Committee</td>
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<tr>
<td>ICB</td>
<td>Industry Classification Benchmark</td>
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<tr>
<td>IFRS</td>
<td>International Financial Reporting Standards</td>
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<tr>
<td>ILW</td>
<td>Imhoff, Lipe, Wright</td>
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<tr>
<td>IRR</td>
<td>Internal Rate of Return</td>
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<tr>
<td>KPI</td>
<td>Key Performance Indicator</td>
</tr>
<tr>
<td>NNN</td>
<td>Triple Net lease</td>
</tr>
<tr>
<td>NPV</td>
<td>Net Present Value</td>
</tr>
<tr>
<td>P&amp;L</td>
<td>Profit and Loss</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>Property, Plant and Equipment</td>
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<tr>
<td>PV</td>
<td>Present Value</td>
</tr>
<tr>
<td>PVLL</td>
<td>Present Value Lease Liability</td>
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<td>RED</td>
<td>Revised Exposure Draft</td>
</tr>
<tr>
<td>REL</td>
<td>Real Estate Lease</td>
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<tr>
<td>ROA</td>
<td>Return on Assets</td>
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<td>ROC</td>
<td>Return on Capital</td>
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<tr>
<td>ROE</td>
<td>Return on Equity</td>
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<tr>
<td>ROU</td>
<td>Right of Use</td>
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<tr>
<td>RVG</td>
<td>Residual Value Guarantee</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission (U.S.)</td>
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<tr>
<td>SFAS</td>
<td>Statement of Financial Accounting Standards (U.S.)</td>
</tr>
<tr>
<td>SLB</td>
<td>Sale and Lease Back</td>
</tr>
<tr>
<td>SLE</td>
<td>Single Line Expense</td>
</tr>
<tr>
<td>SME</td>
<td>Small and Medium-sized Enterprises</td>
</tr>
<tr>
<td>SPV</td>
<td>Special Purpose Vehicle</td>
</tr>
<tr>
<td>WACC</td>
<td>Weighted Average Cost of Capital</td>
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</table>
Defined terms

Commonly used terms in the IFRS lease accounting exposure draft are noted below. These definitions are retrieved from the IASB’s 2010 ED and additional deliberations with the FASB.

Contingent rentals
Lease payments that arise under the contractual terms of a lease because of changes in facts or circumstances occurring after the date of inception of the lease, other than the passage of time.

Date of commencement of the lease
The date on which the lessor makes the underlying asset available for use by the lessee.

Date of inception of the lease
The earlier of the date of the lease agreement and the date of commitment by the parties to the lease agreement.

Initial direct costs
Recoverable costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made.

Lease
A contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration.

Lease liability
The lessor’s obligation to permit the lessee to use the underlying asset over the lease term.

Lease payments
Payments arising under a lease including fixed rentals and rentals subject to uncertainty, including, but not limited to, contingent rentals and amounts payable by the lessee under residual value guarantees and term option penalties.

Lease term
The non-cancellable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a significant economic incentive for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease.

Lessee
An entity that enters into a contract to provide another entity with consideration in return for the right to use an asset for a period of time.

Lessor
An entity that enters into a contract to provide another entity with the right to use an asset for a period of time in return for consideration.

Lessee’s incremental borrowing rate
The rate of interest that, at the date of inception of the lease, the lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to purchase a similar underlying asset.

Rate the lessor charges the lessee
A discount rate that takes into account the nature of the transaction as well as the specific terms of the lease such as lease payments, lease term and contingent rentals.
**Residual asset**
An asset representing the rights to the underlying asset retained by the lessor under the derecognition approach for lessor accounting.

**Residual value guarantee (RVG)**
A guarantee made by the lessee that the fair value of the underlying asset that the lessee will return to the lessor will be at least a specified amount. If the fair value is less than that amount, the lessee is obliged to pay the difference to the lessor.

**Right-of-use (ROU) asset**
An asset that represents the lessee’s right to use, or control the use of, a specified asset for the lease term.

**Short-term lease**
A lease that, at the date of commencement of the lease, has a maximum possible lease term including options to renew or extend, of twelve months or less.

**Sublease**
A transaction in which an underlying asset is re-leased by the original lessee (or ‘intermediate lessor’) to a third party, and the lease agreement (or ‘head lease’) between the original lessor and lessee remains in effect.

**Underlying asset**
The asset for which a right of use is conveyed in a lease.
Introduction

To introduce the subject of this thesis and to explain how the research will be conducted, this chapter will provide an introduction and a clarification of the motivation (§1.1), the problem outline & definition (§1.2), the research objective and questions (§1.3), demarcation (§1.4), research relevance (§1.5), research design (§1.6), and research outline (§1.7) of this thesis.

1.1 Motivation

Corporate real estate (CRE) – “CRE is defined as corporate property – industrial, office and retail space – used for business purposes, as an input into the production process by companies not primarily in the real estate business.” (Nappi-Choulet, Missonnier-Piera, & Cancel, 2009, p. 80) – represents one of the world’s largest asset classes. The discussion about the significance of CRE has been taking place since Zeckhauser and Silverman were the first to explore the world of CRE with their study “Rediscover Your Company’s Real Estate” in 1983. Since then, corporate real estate management (CREM) became a more and more important factor in composing corporate strategies (Brounen & Eicholtz, 2005). Krumm, Dewulf and De Jonge (2000, p. 32) provided the following definition of CREM: “The management of a corporation’s real estate portfolio by aligning the portfolio and services to the needs of the core business (processes), in order to obtain maximum added value for the businesses and to contribute optimally to the overall performance of the corporation.”. CRE operations should, thus, be able to answer to core businesses’ space demand. This is also argued by Nourse and Roulac (1993), who stated that successful CRE strategies are the ones that are aligned with the corporate core business. Since corporations can follow many different corporate strategies, achieving alignment means choosing an adequate CRE strategy and portfolio decision-making process to help support corporate goals (Ramakers, 2008).

CREM has, thus, grown as a professional discipline over the past decades. At almost every organisation, CRE practices have evolved from a narrow definition focusing on managing real estate transactions, design, and construction projects, to managing a wide range of functions that support internal and external business factors (Varcoe & O’Mara, 2011). Figure 1.1 depicts these factors, with a special focus on the regulatory issues, which influence CRE strategies, because the current global financial and economic crisis led to widespread calls for changes in the regulatory system.

![Figure 1.1: Seven focus areas of CRE](Source: Adaption of PwC (2010))

One such project is the proposed change to lease accounting that also complies with the initiated path of the worldwide trend of the desire to improve the safety, transparency, and
efficiency of markets for all participants (OECD, 2009; Crown, 2010; OECD, 2010a; OECD, 2010b). A remarkable development in the decision-making process of CRE divisions is namely the worldwide increasing use of leasing as a form of asset financing during the past twenty years. In Europe, leasing represented volumes worth in excess of €330 billion in 2008 (Leaseurope, 2010). This development is due to the recognition of leases in the financial statements of companies. Currently, leases are divided into two categories: operating leases and finance leases. If a lease is classified as a finance lease it is already shown as an asset and a liability on the lessee’s balance sheet. However, in the case of an operating lease the lessee simply accounts annual lease payments as expenses over the lease term. The leased asset and the total lease obligation under operating leases, thus, do not appear on the balance sheet even though the lessee is using the asset and is contractually obligated to pay for its use. As operating leases allow a lessee to avoid on-balance recognition of the leased asset, its profitability ratios and some key performance indicators (KPIs) are more favourable than if it used finance lease accounting. Brounen and Eicholtz (2005) argue that executives seem to have been discovering off-balance sheet financing and have looked at their property assets more critically, with the result that more and more corporations have opted for CRE leases, which decrease the capital burden and enhance corporate KPIs. This implies that investors and other users of financial statements must estimate the effect of operating leases on financial leverage and earnings. Manning (1991) as well as Brounen and Eicholtz (2005) state that as a result operating leases have become a major source of ‘off-balance’ sheet financing, at the expense of on-balance sheet finance leases since the implementation of the current lease accounting standard in 1982. Moreover, leases have sometimes been ‘tailored’ to achieve operating lease accounting because of these favourable financial statement impact (PwC, 2010; Ernst & Young, 2011; Deloitte, 2012; KPMG, 2012).

Hordijk, Rompelman, and Koerhuis (2010) mention that especially the popular sale and lease back (SLB) transactions created a large quantity of operating lease commitments, in order to clear the corporate balance sheets of real estate exposure, and to gain capital to invest in their core business to increase shareholders’ value. This far from transparent situation led, subsequently, to numerous financial scandals. Well known scandals are, inter alia, Enron in 2001, WorldCom, Xerox, Sunbeam, Waste Management, Adelphia, Tyco, HealthSouth, Global Crossing in the U.S. (Coates, 2007) and, for example, Ahold in the Netherlands. Therefore, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB), jointly issued the exposure draft (ED²) Leases in 2010 (IFRS, 2010; FASB, 2012). The proposed lease accounting changes stipulates that almost all CRE leases, existing and new, have to be capitalised on the lessee’s balance sheet. These proposed accounting rules for listed companies are, thus, especially relevant for those corporations that are significant users of real estate. Changing off-balance sheet accounting to on-balance sheet accounting will mitigate concerns about the safety, transparency and efficiency of off-balance sheet assets and liabilities that result from the application of today’s lease accounting rules. However, one of the main advantages of off-balance sheet accounting -to clear balance sheets in order to improve performance measures- disappears and obligates corporations to overhaul the alignment between their business strategy and CRE strategy. (PwC, 2010; Ernst & Young, 2011; Deloitte, 2012; KPMG, 2012; CBRE, 2010)

It should be noted that the proposed changes to lease accounting are part of a larger set of key pieces of legislation that will become effective the years ahead (Brounen, 2011; Aviva, 2011), namely:

- Lease accounting changes concerning financial reporting for (inter)national publicly traded companies;
- Solvency II concerning EU insurance companies;
- Basel III concerning a global regulatory standard on bank capital;
- The Alternative Investment Fund Managers Directive (AIFMD) concerning the supervision of EU hedge funds and private equity funds;
- European Market Infrastructure Regulation (EMIR) Regulation on central counterparties and trade repositories throughout the EU.

2 An Exposure Draft is a version of a document released internally and opened for discussion before the final document is published.

3 Capitalisation is the calculated current value of a future stream of earnings or cash flows.
As figure 1.1 illustrates, this set of regulatory issues will have its impact on CRE practices. Jones Lang LaSalle (2011) argues that these legislations should help CREM divisions, as a part of the affected corporations, "to be better prepared to address returning growth, as well as the continued uncertainty in some sectors and markets" (p. 4). The CREM divisions, as a result, are experiencing more scrutiny from stakeholders, an increased demand for real-time reporting, and tougher performance targets. The challenge of getting started with these new legislations adds additional complexity to the task of deciding which real estate exposures - e.g. offices, retail, plants - are most appropriate and which CRE strategies and future portfolio decision-making processes are most valuable to implement. Investors, fund managers, insurers, lenders, banks, but above all the CRE users - and therefore the CREM divisions - will, thus, be faced with new demands from a rapidly evolving regulatory environment.

It should, thereby, be noted that Solvency II, Basel III, AIFMD and EMIR are designed solely for a specific group of corporations in a certain industry. The lease accounting changes on the other hand affect an international wide range of corporations in all kinds of industries. Thus, a substantial contribution can be made to the ‘impact on CREM’ literature by examining the proposed lease accounting changes.

1.2 Problem outline & definition
According to figure 1.1 “Regulatory issues“ are one of the seven focus areas of CRE practices. This implies that the proposed lease accounting changes will also have to be dealt with by CREM divisions of listed corporations. PwC (2010), Ernst & Young (2011), Deloitte (2012), and KPMG (2012) argue that the proposed lease accounting changes can act as a catalyst for possible changes in CRE strategies and future portfolio decision-making processes. It is, thus, necessary to describe what the direct consequences of the proposed changes might be for corporations, in order to examine if these consequences can possibly act as a catalyst for changes in CRE strategies and future portfolio decision-making processes.

1.2.1 Problem outline
The IASB (2010) and FASB (2010) argue that, first, current accounting models fail to meet the needs of users because “they do not provide a faithful representation of leasing transactions”. Second, current accounting models lead to complexity and a lack of comparability (corporations can “tailor the numbers” and record liabilities off-balance). As a result, many users of financial statements currently have to rely on estimates based on rules of thumb and information presented in footnotes of financial statements to assess the impact on KPIs.

To address these problems, the lease accounting proposal suggests a completely new model for lessee accounting. This proposal is an accounting regulation and has, thus, its effects on the accounting. However, the most import consequences occur outside the accounting profession. PwC (2010), Ernst & Young (2011), Deloitte (2012), and KPMG (2012) discuss several major consequences for corporations with large operating lease portfolios, namely:

- Training and (IT) resources needs,
- Redefinition of KPIs and impact on financial statements,
- Tax considerations and implications,
- Debt covenants in financing arrangements may have to be renegotiated.

In addition to the effects as a business transformation issue, the lease accounting changes also entail major implications for CREM divisions. These implications are, inter alia, discussed by PwC (2010), Ernst & Young (2011), Deloitte (2012), and KPMG (2012) in the following trichotomy:

- Data management impacts; data collection and implementation challenges of decentralised foreign real estate portfolios. Systems, processes and controls will change because they can no longer be managed in spread sheets because the process is time consuming and prone to errors.
- Portfolio strategy and management impacts; lease versus buy strategy and decisions may change because the advantage of the off-balance sheet accounting will lapse. For this reason sale-leaseback transaction may become less attractive and the length of rental contracts may be reduced.
- Changes to transaction management; re-negotiations and change in common lease terms may alter the transaction process because of the balance sheet increase.

1.2.2 Problem definition
According to the described motivation and problem outline, the problem definition can be stated as:

“The proposed lease accounting changes stipulate to capitalise all operating leases on the corporate balance sheet. Hereby one of the main advantages of the use of operating leases, off-balance sheet accounting, disappears. Besides the financial statement impact and changes to IT for every listed corporation that requires IFRS guidance, three major consequences for CRE managers occur, namely: data management impacts, portfolio strategy and portfolio management impacts, and changes to transaction management.”

1.3 Research objective and questions
This section addresses the research objective and, subsequently, the research questions.

1.3.1 Research objective
Following from the research relevance, the primary research objective is to model the potential impact of the lease accounting changes on the CRE strategies and potential implementation problems for the CRE decision-making processes, in order to develop an understanding of the role of accountancy in the strategic decision-making processes of CREM divisions and to, subsequently, provide tools to manage these possible impacts.

The objective of this study is, thus, not to predict all of the changes that might occur if the proposed lease accounting standards are implemented in their current form, but to provide insight in the impacts that are most likely to occur and to provide tools to manage these impacts.

1.3.2 Research questions
The following research question is determined:

What impact do lease accounting changes have on corporate real estate strategies, and what are the consequences for future corporate real estate operating decisions?

Hereby the research goal is not to supplement the list of changes that might or might not occur due the proposed lease accounting changes, but to understand the role of accountancy within CRE strategy and portfolio decision-making processes. In order to provide a founded solution for this research question, the research question will be subdivided into several sub-questions.
By means of these sub-questions, the research will be structured and the combination of the separate answers on these sub-questions will result in a comprehensive conclusion. The sub-questions are:

1. What are the key aspects of lease accounting and what are the key changes for lessee accounting with respect to CRE?
2. Which CRE strategies can be distinguished and what are their added values in a corporate perspective?
3. Which changes to CRE portfolio decision-making processes can be made to alter the possible impacts of IFRS lease accounting on the corporate financial statement presentations?
4. What are the theoretical implications of the lease capitalisation for AEX listed corporations?
5. What are the practical implications of the lease capitalisation for AEX listed corporations?

1.4 Demarcation

The proposed lease accounting changes are still tentative, therefore, the research and analysis presented in this thesis assumes that a new lease accounting standard will be adopted in the next few years. Furthermore, it should be noted that re-deliberations are continuing, and even the tentative guidelines in the Revised Exposure Draft (RED) could be substantially modified before the final lease accounting standard is ultimately issued. Therefore, the research and analysis presented in this thesis necessarily assumes that the currently proposed standards for lease accounting will ultimately be adopted.

This thesis solely focuses on the impact of lease accounting on listed lessees because of the fact that the accounting rules only apply to publicly traded corporations. As the problem outline has shown, information on corporate financial statements is required in order to be able to examine the impact of the lease accounting proposal. Therefore, this thesis merely emphasises on AEX listed corporations because the required information is publicly available. Also note that these AEX listed corporations demark the research because of the fact that otherwise the research would be too broad and complex since, for example, different market situations and tax situations have to be dealt with. Thereby, solely IFRS lease accounting is covered due to the selection of Dutch large-cap corporations which are required to use IFRS guidance. Other implications, such as tax alterations, due to the proposed lease accounting changes are not in the scope of this thesis because of the focus on CREM.

Given the international scope of the corporations, the outcomes of the analysis are believed to extend the mere geographical boundaries of the Netherlands. Thereby, the sample size for this study is not necessarily representative of the entire population of CRE lessees in the Netherlands. Also note that Unibail Rodamco and Corio, both financials, are left outside the scope of this research because these corporations are excluded by the used definition of CRE.

23 AEX listed corporations, thus, remain in order to involve corporations whose core business is not real estate. Due to the limited timeframe and the complexity of the matter the lessor’s impact is beyond the scope of this research. Rather, this thesis conducts a qualitative research to explore whether certain CRE(M) characteristics, of the AEX corporations, may increase the likelihood for changes in real estate decisions in response to changes in lease accounting requirements. Thereby, the results of this research should be considered, as stated in the motivation, in the wider context of Solvency II, Basel III, AIFMD, and EMIR legislations. Furthermore, CRE managers who understand and appreciate the effects of the rapidly approaching confluence of new legislation will have a major competitive advantage that should provide tangible benefits. Therefore, this thesis will focus on lease accounting, principally from a CRE user’s perspective, and will explore whether the proposed accounting change is likely to influence real estate decision making. The lessees in the scope of this thesis are listed according to the Industry Classification Benchmark (ICB), in table 1.1. (FTSE, 2011)


1.5 Research relevance

The relevance of this thesis is divided in two parts; scientific relevance and practical relevance.

The practical relevance is to understand the implications of the proposed lease accounting rules to Dutch CRE lessees. An ‘endless’ list of publications describing the rules and the reporting implications has been produced. However, the effects of the proposed changes to the lease accounting rules have only been studied in the field of finance and accountancy and, thus, they lack in predicting how the proposed changes might affect the actual real estate decision-making process. Therefore, this thesis analyses the existing studies about real estate strategies and portfolio decisions and aligns those to the proposed changes of lease accounting and the market expectations.

The scientific relevance is to broaden the scientific knowledge on the—interchangeable—impact of the field of accountancy, with lease accounting in particular, on the field of CRE management, with CRE strategic and portfolio decision making in particular. Scientific research conducted between these two fields of industry is scarce. Therefore, this thesis focuses on creating an understanding of the new accounting rules and how it affects real estate decision-making. Furthermore, as far as is known no other similar research, with the focus on CRE, is conducted for Dutch listed lessees.

Table 1.1: 23 AEX listed corporations allocated by industry
1.6 Research design
The research design will explain the basic structure of the thesis according to the chapters that are aligned with the sub-questions.

Chapter 1 Introduction
Within this chapter the problem outline is discussed. The background of the research subject is explained and the scientific and social relevance are clarified. Thereby the definitive research objective, research question, sub-questions, and demarcations are provided.

Chapter 2 Lease accounting
This chapter provides an overview of the developments, background purpose and understanding of lease accounting. It will answer relevant questions as; what is lease accounting? What will change due to lease accounting? Also the theoretical link between the proposed lease accounting rule and CREM will be discussed. It will create an understanding of which factors and theories may be influenced by lease accounting. Sub-question 1; “What are the key aspects of lease accounting and what are the key changes for lessee accounting with respect to CRE?”, will be answered in this chapter.

Chapter 3 Corporate real estate strategies
In this chapter the field of real estate strategies is explored. Based on scientific studies, CRE strategy theories will be evaluated and clarified. Sub-question 2; “Which CRE strategies can be distinguished and what are their added values in corporate perspective?”, will be answered in this chapter.

Chapter 4 Corporate real estate decision-making
Chapter 4 finalises the literature study by analysing scientific studies about CRE decision-making processes. It will define which factors contribute and have an impact on strategic decision-making. This will lead to an overview of which factors influence CRE decision-making concerning the IFRS lease accounting project. Sub-question 3; “Which changes to CRE portfolio decision-making processes can be made to alter the possible impacts of IFRS lease accounting on the corporate financial statement presentations?”, will be answered in this chapter.

Chapter 5 Macro analysis
To understand the effect that the proposed lease accounting would have on the financial statements of AEX listed corporations; the impact is determined due to a macro analysis of the corporate balance sheet and the income statement. Sub-question 4; “What are the theoretical implications of the lease capitalisation for AEX listed corporations?”, will be answered in this chapter.

Chapter 6 What is the market expecting?
By means of expert interviews, supported with the macro analysis and hypotheses, the knowledge and information of the literature research will be combined with more practical information. A representative market expectation is clarified due to interviewing a wide spectrum of experts. Sub-question 5; “What are the practical implications of the lease capitalisation for AEX listed corporations?”, will be answered in this chapter.

Chapter 7 Conclusions & recommendations
The final chapter will summarise the findings and conclusions on all the sub-questions and the research question; “What impact do lease accounting changes have on corporate real estate strategies, and what are the consequences for future corporate real estate operating decisions?”, will be answered. Furthermore, it provides a reflection on the thesis and recommendations for further research.
1.7 Research outline
The second part of the research is conducted in the form of interviews with several professionals within the field of the real estate industry, varying from accountants, CRE managers, consultants and bankers to form a broad and deep perspective of the role of lease accounting within the real estate decision making process. See figure 1.2 for a schematic view.
IFRS lease accounting impact on Corporate Real Estate Management
Lease accounting

Understanding the basics of financial reporting is key in the process of understanding what impact accounting rules can have on CREM. This chapter explains, therefore, the effect of lease accounting by providing; an overview of the developments and background purpose of lease accounting (§2.1), the key changes for lessee accounting (§2.2), the theoretical link between the proposed lease accounting changes and CREM (§2.3), the time plan of the lease accounting project (§2.4), and the conclusion (§2.5). The goal of this chapter is to answer sub-question 1; “What are the key aspects of lease accounting and what are the key changes for lessee accounting with respect to CRE?”, with a specific focus on AEX listed lessees.

2.1 Overview and background
Credit ratings provided by rating agencies, such as Moody’s, Fitch and Standard & Poor’s, debt covenants contracted with creditors, such as banks, and investment decisions of investors are all subject to reliable and relevant information about a corporation’s financial position, profitability, and risk. Financial statements, prepared by corporations, are one of the most important sources for this information (Lückerath-Rovers, 2007). The financial statements comprises four parts and provide information about; 1) a corporation’s financial position (balance sheet), 2) its profitability (statement of profit and loss (P&L)), 3) its cash-generating activities (statement of cash flows), and 4) its changes in shareholders’ equity. The financial statements should be read in conjunction with the supporting notes, which provide further details concerning the reported data. (Stickney, Weil, Schipper, & Francis, 2009)

2.1.1 Financial reporting: two flavours
The process of preparing the financial statements of a corporation is called financial reporting. Corporations apply accounting standards (or rules) to prepare their financial statements. The most important accounting systems are the International Financial Reporting Standards (IFRS) and the United Stated Generally Accepted Accounting Principles (U.S. GAAP). IFRS and U.S. GAAP are two similar—but not identical—financial accounting systems which contain guidance on what data the financial statements must contain. These standards are produced by two independent bodies; the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB).

The FASB is based in the United States and came into existence after it replaced the Committee on Accounting Procedure and the Accounting Principles Board of the American Institute of Certified Public Accountants (AICPA) in 1973. The Securities and Exchange Commission (SEC) designated the FASB as the organisation responsible for setting accounting standards for public corporations in the U.S.. The FASB focuses on the development of United States Generally Accepted Accounting Principles (U.S. GAAP) and issues its ‘rules’ in the form of Statements of Financial Accounting Standards (SFAS). These standards have both a number (for example, SFAS 13), a title (for example, “Accounting for leases”) and regulate the preparation of financial reports in the U.S. for public, private, and non-profit entities. This results in financial reports that provide useful information for investors, creditors, and credit rating agencies. (FASB, 2007)

The predecessor of the IASB, the International Accounting Standards Committee (IASC), was also created in 1973, to establish the first international accounting standards. The IASB came into existence in London in 2001. The IASB is committed to “developing a single set of high-quality, global accounting standards that require transparent and comparable information in general purpose financial statements”, known as the IFRS regulations.
IFRS includes the International Accounting Standards (IAS) that were set by the IASB’s predecessor, the IASC. These IASs have, also, both a number (for example, IAS 17) and a title (for example, “Leases”). The IASB cooperates, as the independent standard-setting body of the IFRS Foundation, with national accounting standard setters to achieve convergence in accounting standards around the world. Over one hundred countries require listed corporations to use IFRS, or standards based on IFRS, to prepare their financial reports or have announced plans to do so. Each of these countries, including the Netherlands since 2005 (Cox & Petersen, 2002), has its own regulatory arrangements for handling the application of IFRS. (IFRS, 2012)

The IFRS rules are substantively influenced by U.S. GAAP and are therefore stated to be very much alike. The differences between IFRS and U.S. GAAP are manifested in the approach of drafting the legislations. IFRS is referred to as being principles-based, while U.S. GAAP is more rules-based. It is estimated that, if printed, IFRS would take up about 2.000 pages, while U.S. GAAP would amount to about 25.000 pages. With fewer pages and less specifics, IFRS often lacks the very detailed guidance included in U.S. GAAP but it allows more professional judgement. Regardless of differences in size, both U.S. GAAP and IFRS have the same goal of achieving transparency and full disclosure financial reports. (Vergoossen & Wel, 2002; Smith, 2011)

Figure 2.1 shows the geographic areas that require IFRS (green), are pursuing adoption of IFRS (light blue), or require U.S. GAAP (dark blue). IFRS adaption is required if a corporation is publicly traded on, for example, the Dutch AEX.

However solely AEX listed corporations are in the scope of this thesis, it should be noted that small and medium-sized enterprises (SME) often can choose which accounting standard they use; IFRS/U.S. GAAP, depending on their geographical location, or the national regulatory arrangement.

2.1.2 Accounting for leases today
Stickney et al. (2009) indicate that (listed) corporations make investments, such as acquiring office space, retail space or production plants, to support their primary business activities. Investing activities, thus, involve acquiring property, plant, and equipment (PP&E), with long-term borrowing.
Corporations require financing to carry out their long-term borrowing plans, and that wish to use debt as a means of obtaining cash, will:

- Borrow from commercial banks, insurance companies, or other financial institutions,
- Issue bonds in the capital markets, or,
- Lease the asset from its owner, i.e. the lessor.

This third alternative to borrowing cash demonstrates that leasing is an important source of financing. Therefore, it is important that the lease accounting guidance provide users of financial statements with a complete and understandable picture of a corporation’s leasing activities.

In 1976, the FASB attempted to provide guidance on how these long-term leases should be reported on financial statements through its issuance of the Statement of Financial Accounting Standard No. 13 (SFAS 13). The concepts and definitions of lease accounting introduced by SFAS 13 were adopted by many countries and organisations. The IASC, the predecessor of the IASB, in its turn, issued the International Accounting Standards No. 17 (IAS 17) in 1982. Guidance on the lease project is, thus, provided by the IASB and FASB in the form of standards, IAS 17 and SFAS 13.

Paragraph 2.1.1 discussed that if a Dutch listed corporation is considered, it has to prepare its financial statements according to IFRS requirements. In this case, the corporation is required to follow IAS 17 Leases prescriptions. Since the transaction between a lessor and a lessee is based on a lease agreement, it is appropriate to use consistent definitions. IAS 17 defines a lease as: “An agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.”. The goal of IAS 17 is to provide the appropriate accounting policies and disclosures to apply for lessees and lessors in relation to finance leases and operating leases. (IFRS, 2005)

The classification of a lease concerning IAS 17 Leases is based on; “the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee.”. This approach is called the ‘risk and reward approach’ and is based on the fact which actor, the lessee or lessor, bears the most of risks and rewards related to the ownership of the real estate asset. Risks include the possibilities of losses from vacant space or technological obsolescence and losses from variations in return because of changing economic conditions. The gain from realisation of a residual value or appreciation in value can be viewed as rewards. (Holt & Eccles, 2001)

The current risk and reward accounting approach provides two possibilities; the lessee bears substantially all risks and rewards of the ownership of the asset or the lessor bears substantially all risks and rewards of the ownership of the asset. If the lease transfers substantially all the risks and rewards incident to ownership from lessor to lessee then the lease is classified as a finance lease. If the risks and rewards of ownership are not transferred to the lessee, the lease is classified as an operating lease. See figure 2.2 and 2.3 for a schematic view. (IFRS, 2005)
The exact cases when the risks and rewards of ownership are transferred are provided by the guidelines provided by IAS 17 (IFRS) and SFAS 13 (U.S. GAAP). The ‘choice’ if a lease is an operating lease or a finance lease is made at the inception of the lease. The guidelines are as follows: (FASB, 2007; IFRS, 2012)

**SFAS 13**
A lease is classified as an operating lease or a direct capital lease according to four rules (“bright-line” tests). A lease is a capital lease if any of the following rules are met:

- The lease transfers ownership of the leased asset to the lessee at the end of the lease term.

- Transfer of ownership at the end of the lease term seems likely because the lessee has a bargain purchase option. A bargain purchase option gives the lessee the right to purchase the leased asset at a specified future time for a price less than the currently predicted fair value of the property at that future time.

- The lease extends for at least 75% of the asset’s expected useful life.

- The present value (PV) of the contractual minimum lease payments equals or exceeds 90% of the fair value of the asset at the time the lessee signs the lease. The present value computation uses a discount rate appropriate for the creditworthiness of the lessee.

**IAS 17**
A lease is classified as a finance lease or operating lease based on whether it transfers substantially all the risks and rewards incidental to ownership of the asset. The following indicators that a lease is a finance lease are provided:

- The lease transfers ownership of the asset to the lessee by the end of the lease term.

- The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised.

- The lease term is for the major part of the economic life of the asset, even if title is not transferred.

- The lease assets are of a specialised nature such that only the lessee can use them without major modifications being made.

*The SFAS 13 bright-line tests are, in practice, often used to interpret the IAS 17 indicators; ‘major part’ and ‘substantially all’ (hence the principle based character).

If any of the rules above are met the lease would, thus, be considered a finance lease. On the other hand, if none of the criteria are met, the contract is an operating lease. One can imagine that, for example, an airplane or a real estate asset is being leased for ten years, while the economic life is fifty years. The contract will be, thus, an operating lease. Figure 2.4 illustrates a schematic approach of the lease-classification test according to IAS 17, and the related quantitative indications of SFAS 13.

7 IAS 17 distinguishes between inception and commencement of leases. The terms may represent different instances of time. Inception of the lease is the date of the lease agreement. While the commencement of the lease is the date from which the lessee is entitled use the leased asset. (IFRS, 2005)

8 IFRS guidance uses the term ‘finance lease’, which is equivalent to the term ‘capital lease’ under U.S. GAAP guidance.

9 In accounting and economics, fair value is a rational and unbiased estimate of the potential market price of a good, service, or asset.

10 Additionally, if the term of the lease does not exceed twelve months, including renewal options, the lease may be considered as “rental” and does not need to be disclosed in lessee's footnotes.
The accounting treatment of a finance lease is economically similar to purchasing the asset with a loan. At the end of term, the corporation has many options available. The lessee has the option to purchase the asset, return the asset to the lessor, or extend the term of the lease. If the lessee chooses to purchase the asset at the end of the lease term, consequently the costs of ownership may be low.

In the case of an operating lease, only the right to use the asset is transferred from the lessor to the lessee. At the end of the lease term, the lessee has many options available; 1) the lessee can choose to return the asset to the lessor, 2) purchase the asset, or 3) extend the term of the lease and continue to make payments. If the lessee chooses to purchase the asset at the end of the lease, the costs of ownership can be very high. Furthermore, the fair value in an operating lease cannot be pre-negotiated. Stickney et al. (2009)

One key aspect has not been mentioned; the difference between the treatment of an operating lease and a finance lease. The IAS 17 criteria showed that operating leases are relatively short-term leases compared to the economic life of the asset. For that reason, operating leases are accounted as operating expenses. This means that they are treated different in the financial statements of a corporation. This is remarkable because leases are often been seen similar to financing the purchase of an asset. The difference has consequences for, especially, the balance sheet, income statement (P&L) and the additional notes and disclosures. Of course, the total amount of payments remains unaffected by operating and finance leases. Table 2.1 shows these differences in requirements. (IFRS, 2005; Lückerath- Rovers, 2007)

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<thead>
<tr>
<th>Balance sheet</th>
<th>Income statement (P&amp;L)</th>
<th>Notes</th>
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<tbody>
<tr>
<td>Finance lease</td>
<td>Fair value of the assets or, if lower, the present value (PV) of the minimum lease payments.</td>
<td>1) For each class of asset, the net carrying amount at the end of the reporting date. b) the total of future minimum lease payments and their present value for each of the following periods, expiring: 1) within one year, 2) between one and five years, and 3) after five years. c) Contingent rents recognised as an expense in the period. d) Total of future minimum sublease payments expected to be received under non-cancellable subleases. e) A general description of the lessee’s material leasing arrangements.</td>
</tr>
<tr>
<td>Operating lease</td>
<td>No information.</td>
<td>a) the total minimum of future lease payments and their present value for each of the following periods, expiring: 1) within one year, 2) between one and five years, and 3) after five years. b) Total of future minimum sublease payments expected to be received under non-cancellable subleases. c) Lease and sublease payments recognised as an expense in the period, with separate amounts for minimum lease payments, contingent rents, and sublease payments. d) A general description of the lessee’s material leasing arrangements.</td>
</tr>
</tbody>
</table>

Table 2.1: Operating leases and finance leases in the financial statements of lessees according to IAS 17 disclosure
Source: Lückerath- Rovers (2007)
The most important difference, first of all, is the different place where one can ‘find’ the lease obligations. The accounting treatment for an operating lease is straightforward. In case of an operating lease, as table 2.1 shows, no information is provided on-balance but the rental payments are recognised as an operating expense in the income statement on a straight-line basis. See figure 2.5.

In addition to the straight-line expense in the income statement, the lessee has to disclose the amount of the payments the corporation has to make in the following years. This has as a consequence that the user of the financial statements is not provided with the PV calculations of the operating leases and therefore has to estimate the PVs if an on-balance equivalent is wished. In addition it should be noted that the disclosure requirements for financial leases in the notes are more extensive than the disclosure requirements of operating leases. This is remarkable because no other information for operating leases is required by IAS 17. (Lückerath-Rovers, 2007; Stickney et al., 2009)

In the case of a finance lease, the corporation leasing the asset has to record the real estate asset as an asset on the balance sheet, and the corporation has to recognise a liability on the balance sheet, by an amount equal to the PV of the minimum lease payments. The lessee splits, thus, the finance lease in a right-of-use (ROU) asset and a liability to account it for on-balance. The future lease payments are discounted at the lessee’s incremental borrowing rate for capital or the rate implicit in the lease. A finance lease payment includes two components: one is the interest expense and the second component is the principal payment. The interest portion will be higher at the inception of the lease and corresponds to the interest expense of an amortised loan. See figure 2.6. (Lückerath-Rovers, 2007; Stickney et al., 2009)

Furthermore, operating leases do not add up to the total amount of liabilities (i.e. debt) that is recorded on the balance sheet because operating leases do not exist out of a liability and an asset. Thus, when an operating lease is acquired no liability is put on the balance sheet albeit the lessee has signed a lease contract and is obligated to make lease

11 The lessee’s incremental borrowing rate is the rate the lessee would have incurred either under a similar lease (IAS 17) or to borrow over a similar term the funds necessary to purchase the asset (SFAS 13). The rate implicit in the lease is the IRR. The lessee uses the implicit rate if known (or the lower of the two).

12 Amortisation is the same as depreciation, but in practice amortisation is used for intangible assets while either term is used for tangible fixed assets. Intangible assets are non-monetary amounts that cannot physically be measured.
payments. The opposite is the case with finance leases. Whereas, in the case of a finance lease, all the future payments are capitalised on the lessee’s balance sheet, much the same as if the lessee had borrowed to purchase the asset. The finance lease method, thus, results in a larger amount of long-term debt than it would be the case with the operating lease method. Simply put because the total amount of debt recorded on the balance sheet increases with the use of finance leases and with the use of the operating lease method no debt is recognised on the balance sheet. (Stickney et al., 2009)

For a more in depth explanation on IFRS and U.S. GAAP, see for example; Deloitte (2012a-d), Stickney et al. (2009) and Lückerath-Rovers (2007).

2.1.3 History of the lease accounting project

“I can guarantee almost all of you here have never flown in a plane that has appeared in the airline’s balance sheet. And the reason is they tend not to buy them, they lease them. And we all have leasing standards, and the great news is these leasing standards are perfectly harmonised worldwide. They are all absolutely useless. None of them work.”

(Tweedie, 2002)

The citation is taken from a speech of Sir David Tweedie, ex-chairman of the IASB, which stresses the problem with lease accounting today; it is not giving a transparent picture of a corporation’s financial statement (i.e. the total amount of liabilities / debt).

The origin of the findings of Sir David Tweedie lays in the fact that corporations highly increased the usage of operating leases since they have noticed the advantages of using operating leases instead of finance leases. The advantage that, as section 2.1.2 explained, operating leases do not add up to the total amount of debt on the balance sheet. Lessees could prefer, if IFRS guidance provides the option, to use the operating lease method instead of the finance lease method, since a larger debt ratio makes a corporation appear more risky. (Stickney et al., 2009)

Research conducted by Beattie, Edwards, and Goodacre (1998) discussed the estimation that the number of operating leases is approximately thirteen times larger than the number of finance leases. Goodacre (2002) supported this finding with the statement that in the U.K. the use of operating leases has grown considerably, at the expense of finance leases. Figures 2.7-2.9 illustrate the increasing importance of off-balance operating leases.

Studies of Lückerath-Rovers (2007) in the Netherlands (figures 2.8 and 2.9) and the SEC in the U.S. (SEC, 2005) also support these findings. Although the data used in the figures 2.7-2.9 seem outdated, they still support the suggestion of increasing importance of off-balance operating leases. The significant growth of the use of operating leases would not be a cause for concern if the leasing sector was a small sector. However, considering that, according to
Leaseurope (2010), the leasing sector in Europe represented volumes worth in excess of €330 billion in 2008, CBRE (2009) estimates the value of European real estate assets at around €2.25 trillion, and according to Brounen (2004) it contains on average one third of the tangible fixed assets on the balance sheet, it thus is a sector to take in account.

The growth of the use of operating leases has not gone unnoticed and has raised concerns with regulators. The SEC (2005, p. 63), for example, provided a study on operating lease activities and states about the current lease accounting standards; “many issuers involved in leasing, structure their lease agreements to achieve whatever accounting objective is desired. This structuring of leases in order to meet various accounting, tax and other goals has become an industry in itself during the last 30 years.” This means that lessors are explicitly ‘tailoring’ leases so that they take the form of an operating lease. This structuring of leasing is also called ‘off-balance sheet accounting’. It is not so much that these leases are not shown on-balance but it is the fact that this way of accounting lacks transparency. As table 2.1 shows, IFRS requires that only operating leases are disclosed in the notes of the financial statements. Judging from notes alone it can be very hard to accurately estimate operating lease obligations. Therefore, credit rating agencies, such as Moody’s, Fitch and Standard & Poor’s, systematically calculate the existence and size of operating leases and put them on-balance when determining credit ratings. Altamuro, Johnston, Pandit, and Zhang, (2008, p. 22) confirm in their study that: “lenders can proxy for the incremental risk effect of operating leases by using credit ratings. (...) In the absence of a credit rating, we find evidence that bank loan spreads are better explained by adjusting financial ratios for the capitalization of operating leases.”. This means these credit rating agencies make the right adjustments concerning operating leases, which is not surprising since they have insight in virtually all corporate information when they provide a credit rating. However, according to Standard & Poor’s (2010) this does not mean that, in some cases, amounts that corporations would report may differ significantly from their current adjustments. Furthermore, investors will, in the cases where credit ratings are not provided have to estimate the amount of off-balance sheet leases by themselves.

This raises the risk that these obligations will not be considered appropriately by a user of the financial statements. For example, investors need to know what the amount of debt of a corporation is because it can affect KPIs. This means that investment decisions can change if the exact details of corporations’ obligations are known. This risk factor is also discussed by Healy and Palepu (2003) and Coates (2007). They argue that because major corporate accounting scandals took place at Enron in 2001 and, inter alia, WorldCom, Xerox, Sunbeam, Waste Management, Adelphia, Tyco, HealthSouth, Global Crossing, not every investor was aware of the off-balance sheet accounting of these corporations. Billions of debt from failed deals and projects were kept off-balance through the use of special purpose entities (SPEs) and the structuring of leases. This made investors lose billions of dollars when the share prices of these corporations collapsed because of these scandals. Off-balance sheet financing such as operating and synthetic leases, thus, not only inflates corporate earnings and misrepresents their financial positions, but it allows them to maintain the ratios they need to satisfy debt covenants with lenders. Thereby, it should be stated that operating leases are not always abused. In many cases operating leases are truly the rental agreements that they should be packaged as. (Edman, 2011)

As a result, the Sarbanes-Oxley Act was adopted in 2002 to solve the problems that had occurred with the auditing of U.S. corporations. In response to this act, the IASB and FASB started with a project to develop a global financial reporting system in 2006, including reporting for leases, which would have to prevent these major Enron scandals. Transparency to the users of financial statements was key in this project. The IASB and FASB together, issued two preliminary documents to describe the goals of the convergence project, the “Norwalk Agreement” in 2002 and the “Memorandum of Understanding” in 2006 (that was updated in 2008). The Norwalk Agreement described the intentions of the IASB and FASB to create a set of accounting standards that was the same around the global. The IASB and FASB noted eleven separate areas of financial reporting between the IFRS and U.S. GAAP standards in the Memorandum of Understanding that needed improvement. One such ‘improvement project’ was, and still is, the commitment to develop a global standard for lease accounting. The view of the IASB and FASB concerning this project has been published as a discussion paper.
This ED should provide a detailed view for how financial reporting would change to achieve the desired balance sheet transparency and called for additional comments from the public sector. Under normal circumstances, the IASB and FASB would release the final standard not much later than the time of issuing the ED. However, due to the large amount of comment letters that were received—approximately 800, which is an extraordinary number concerning an accounting rule—, resulted in re-deliberations of the lease accounting ‘problem’. Overall the comment letters supported the on-balance sheet accounting for all leases but there was great commotion about inter alia the proposals about contingent rents, lease options, the required regular reassessment and the fact that the proposals would result in volatile balance sheets and income statements. Despite the large amount of comment letters that were reviewed and meetings that were held for obtaining feedback, decided the IASB and FASB to announce that they would issue the RED in Q4 of 2011. This timeframe has proved to be too tight because one issue had delayed the process. This issue was the desire of the FASB, after a lobbying offensive\textsuperscript{16} of U.S. public corporations, to apply a dual lease accounting model contrary to the IASB that had a preference for just one model for all leases. The dual model, further discussed in section 2.2, is a compromise where the impact on real estate leases is lightened compared with the proposals in the 2012 ED. While the lease accounting project had started because one agreed that leases that are an important way of financing corporate assets and should, thus, be accounted for on-balance. Nevertheless, the IASB and FASB tentatively agreed on the dual accounting model in their June 2012 meeting. (PwC, 2012)

2.2 The future of lease accounting

The dual lease accounting model requires all operating leases, except leases with a lease term less than twelve months\textsuperscript{17}, to be capitalised on the corporate balance sheet. The new lease-accounting approach, called the asset and liability approach, replaces the current risk and reward approach. Leases are no longer aligned according to which party bears the risks and rewards but on the principle that all leases contain an asset and a liability associated with the underlying transactions and events. Thus, in this view, the accounting demands to identify the assets and liabilities, and to identify changes in those assets and liabilities, that subsequently are valued on the corporate balance sheet. (Hepp & Brady, 2011)

2.2.1 Key changes for lessee accounting

The ED Leases (2010) defines a lease as: “a contract in which the right to use a specified asset is conveyed, for a period of time, in exchange for consideration. At the date of inception of a contract, an entity shall determine whether the contract is, or contains, a lease on the basis of the substance of the contract, by assessing whether:"

- The fulfilment of the contract depends on providing a specified asset or assets (the ‘underlying asset’); and
- The contract conveys the right to control the use of a specified asset for an agreed period of time.”

Furthermore, it should be noticed that ‘grandfathering’ of leases is not allowed. This means that the new lease accounting proposals are required for new and also for existing lease contracts. The asset and liability approach that the proposed accounting model for lessees prescribes is called a right-of-use (ROU) model, meaning the lessee has a right to use the leased item. This model will be applied to all leases within the scope of the proposal. Under this model, the lessee obtains not the asset but the right to use (hence the name of the model) the asset for a specified period. For the use of this asset the lessee will report an asset, i.e. the right to use asset, and a liability on its balance sheet for its obligation to pay rent. The figures 2.10 and 2.11 show a schematic view. The ROU asset and the liability will be measured at the PV of all future lease obligations. Any initial costs (e.g., legal fees, consultant

\textsuperscript{16} Quote of Hans Hoogervorst, chairman of the IASB, at his LSE speech in November 2012: “As the financial crisis was caused by excessive leverage, our efforts to shed light on hidden leverage should be warmly welcomed around the world. The fact is that we are still facing an uphill battle. We will need all of the help we can get, to ensure that we do not get lobbied off course”.

\textsuperscript{17} The following leases are outside the scope of the proposed accounting standard:
- Leases of intangible assets (Accounting Standards Codification (ASC) Topic 350 Intangibles - goodwill and other);
- Leases to explore for or use minerals, oil, natural gas, and similar non-renewable resources; and,
- Leases of biological assets (ASC Topic 905 Agriculture).
fees, commissions paid) that are directly attributable to negotiating and arranging the lease have to be included in the ROU asset. (Deloitte, 2012; Tahtah & Spek, 2012)

The IASB and FASB compromised, as stated in section 2.1.3, on a dual based approach for lessees. This means that there are two possibilities to account for every lease that is entered, namely:
- The interest and amortisation (I&A) method, or,
- The straight-line-expense (SLE) method.

The I&A method is the same approach as was proposed in the 2010 ED and the SLE method is the lightened option for, in particular, real estate leases. To determine which method should be applied, the IASB and FASB introduced, again, a dividing line.

The lessee has to determine, with the assistance of a lease classification test – likewise to the current bright-line test –, which method should be applied on the basis of whether the lessee acquires or ‘consumes’ more than a significant portion of the underlying asset. In addition the IASB and FASB decided that lessees could use the nature of the underlying asset as a practical tool to determine what part of the underlying asset is consumed – i.e. thus of the I&A method or the SLE method should be used-. Figure 2.12 depicts this tool in the form of a decision tree. Lessees can assume that, as a practical aid, it does not acquire and consume a significant portion of the underlying asset if the underlying asset is “property,” which is defined as “land or a building -or part of a building- or both.” The lease classification test (thus also the decision-tree in figure 2.12) will contain the same indicators, i.e. ‘major part’ and ‘substantially all’, as used in the IAS 17 guidelines today. (Deloitte, 2012; Tahtah & Spek, 2012)
The IASB and the FASB emphasised on the rationale behind the classification test. One could experience the situation in which the lessee is making payments to finance the acquisition of the part of the underlying asset that is used or the situation in which the lessee is solely making payments in order to use the asset. The rationale is, thus, that with most real estate leases lessees do not consume a significant part of the underlying asset during the lease term, while in virtually all other leases, a significant part of the underlying asset during the lease term is consumed. With the current IAS 17 and SFAS 13 guidance is it not important to distinguish between real estate and assets other than real estate in order to assess a classification. This situation, thus, changes under the proposed guidance, which obliges a company to apply additional judgement to determine whether the leased asset is a real estate asset. This will not be difficult in most cases, however, several situations could require additional research. This is illustrated with three examples in table 2.2. (Ernst & Young, 2012)

<table>
<thead>
<tr>
<th>Lease contract I</th>
<th>Outcome I</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease of a manufacturing plant with two large pieces of equipment installed. The lessor does not lease or sell the equipment items separately, but other suppliers do so.</td>
<td>Three components: one property lease and two equipment leases.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Lease contract II</th>
<th>Outcome II</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease of a large power turbine housed in a building together with the associated land. The building exists only to house the turbine, and will be demolished when the turbine is dismantled.</td>
<td>Equipment lease only, since the primary asset is the turbine.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Lease contract III</th>
<th>Outcome III</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease of an oil storage tank, with land including access area as well as that on which the tank is situated.</td>
<td>Equipment lease only, since access area is not primary.</td>
</tr>
</tbody>
</table>

Table 2.2: I&A method or the SLE method?
Source: Ernst & Young (2012)

The two approaches deliver, as stated, different outcomes to account for in the financial statements of the corporation because the SLE method is a lightened version. But what does this exactly mean? The similarities of the lease approaches, discussed in figure 2.12, are that under both models, the lessee will have to recognise a ROU asset and a lease liability for each lease. The lessee measures the lease liability initially at the PV of the lease payments and measures the ROU asset initially at an amount equal to the lease liability (plus prepaid rentals and initial direct costs). However, in case of the SLE approach, leases are accounted for on a straight-line basis, irrespective of whether this is the pattern of consumption for the underlying asset. This would, again, be the case for many real estate leases. When applying the SLE approach, a lessee is required to (Deloitte, 2012; Tahtah & Spek, 2012):
- Once recorded, amortise\(^1\) the lease liability,
- Calculate the total lease expense on a straight-line basis (hence the name of the approach) and account one single payment item in the income statement,
- Adjust the carrying amount\(^1\) of the ROU asset by the difference between the total lease expense and the interest expense on the lease liability.

As stated, all leases will be recognised as a ROU asset and a liability but to obtain the straight-line, in the case of real estate leases for property leases, the ROU asset will be amortised as a balancing figure. The amortisation of the ROU asset and the interest expense of the lease liability are added up and showed as a single-line item in the income statement. See figure 2.13.

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18 The term carrying amount is often used in place of book value. The carrying amount refers to the amounts that the company has on its books for an asset or a liability. For example, the carrying amount of a company’s truck is the cost of the truck minus the accumulated depreciation on the truck.
Leases are, on the other hand, accounted as financing transactions with an accelerated pattern by using the I&A method. This would be the case for many equipment leases such as car leases. When applying the I&A approach, the lessee would (Deloitte, 2012; Tahtah & Spek, 2012):

- Once recorded, amortise the lease liability and show the interest expense in the income statement (hence the ‘I’ in the name of the approach),
- Amortise the ROU asset on a straight-line basis and recognise the amortisation expense in the income statement (hence the ‘A’ in the name of the approach),
- Show the total lease expense on a front-loaded basis.

The ROU asset will be amortised equal to other non-financial assets. Corporations will have to separately account for the interest expense and the amortisation expense in the income statement. The front-loading aspect means that the total expense will be accelerated in the early periods, due to the differences in amortisation of the ROU asset (straight-line) and the interest expense (decreasing). The ROU asset amortises, thus, at a faster rate than the lease liability because it uses the straight-line method to amortise while the lease obligation uses the effective interest method to amortise similar to a mortgage. Figure 2.14 illustrates the I&A approach which explains the front-loading aspect.

The front-loading aspect was a major concern in the 2010 ED because of two issues; 1) it diverges the accounting from the economic reality (monthly rental payments are straight-lined) of the lease contract, and 2) the difference in accounting for the asset and the liability (straight-line ROU asset and decreasing interest component) causes the balance sheet to be unequal throughout the lease term (the difference is cleared with equity recognition). This difference may be unimportant for small leases, but for larger leases such as real estate, this difference can significantly impact the financial statements. Therefore, the IASB and FASB introduced the SLE accounting approach wherein the front-loading aspect is ‘removed’. (Deloitte, 2012)
A corporate real estate lease example

In section 2.2.1 a real estate lease example concerning the implementation of the dual accounting model for lessees is discussed. Figure 2.15 considers details of an ‘ordinary’ lease of an asset. The accounting process for the lessee is illustrated according to these assumptions. If the leased asset would be a car, the lease would likely be accounted for according to the I&A approach. If the asset being leased is space in an office building, the lease would likely be accounted for according to the SLE approach.

Table 2.2 highlights the differences in accounting for the lease example concerning the I&A approach and the SLE approach. The calculation is made to obtain the ‘minimum lease payments’. IAS 17 (2003, p. 7) defines them as: “Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, (…)”. Furthermore, the letters ‘X’, ‘Y’ and ‘Z’ clarify the way the calculations should be executed. Additionally, the effective-interest method is used to calculate the lease liability, and the ROU asset, in case of the I&A method, is deducted with the straight-lined amortisation expense (Y).

It should be noted that the total amount of minimum lease payments do not change under any circumstance, i.e. in the case of both the proposed models as in case of the current situation the same amount of payments is made each term. If the addressed lease example is ‘entered’ in the decision tree (figure 2.12), one can verify that the SLE approach should be applied; 1) The leased asset is property, and 2) the lease term is not a major portion of the asset’s economic life and the PV does not account for substantially all of the asset’s fair value. Therefore, would solely, in this example, a single-line lease expense in the income statement be accounted for, and a ROU asset and lease liability in the balance sheet. The way the payments are accounted for, however, do change. Figure 2.16 visualises the variables of the real estate lease example and illustrates the dissimilarity between the ROU asset and the lease liability during the lease term because of the differences in expense payments between the two approaches. Chapter 5 provides more details concerning the notation of the ROU assets and lease liabilities in the financial statements.
The extent of the adjustments increases or decreases depending on the number of variables specified in the lease contracts. These variables refer to typical lease situations that defer from a simple lease contract, as discussed with the lease example. These more complicated parts of lease contracts are; contingent rentals, renewal options, subleases, sale and leaseback transactions, lease incentives, and changing discount rates. Canon and Fenbert (2011) argue that corporations are able to structure leases with these variables cases to acquire a PV lease liability less than 90% of the fair value of the real estate asset and avoid capitalisation. For example, changing the discount rate used to calculate the PV and changing the base rent part versus the contingent rent part. Because CRE managers have to deal with these kinds of these situations, they, therefore, are discussed briefly.

2.2.3 Impact of lease capitalisation on corporate KPIs

The proposed dual lease accounting system results in a different way to account for leases. As stated, this causes the gross-up of balance sheets as a result of the assets and liabilities which will appear on-balance. However, more important are the impacts of those changing ways of accounting on KPIs. Nijsten (2012) mentions that investors, credit rating agencies, and banks heavily rely on corporate data (such as the number of leases) to determine risk calculations and performance measurements. These risk calculations and performance measurements are commonly expressed in financial ratios; KPIs. A change to these KPIs may result in existing debt covenants being breached. This means that for corporations the changes can have an effect on risk based capital requirements. KPIs make it possible to easily benchmark between corporations. KPIs can be distinguished in ratios that measure the capacity of a corporation in order to comply long-term and short-term debts. On the other hand, there are ratios that test the profitability of a corporation. This section will discuss the implications on solvability and liquidity ratios and profitability ratios as EBIT, EBITDA\(^{21}\) and ROA.

Lückerath-Rovers (2007) indicates that Nelson was the first to conduct a study on the impact of capitalisation on financial ratios in 1963. Nelson (1963) argues that operating lease information is relevant, and that reliability improves when the operating lease obligations are capitalised. Imhoff et al. (1991) analysed 28 U.S. corporations. The impact on return on assets (ROA) was -22% and the debt-equity ratio (i.e., the corporate solvability indicator) changed 119%. They concluded that capitalisation of operating lease obligations is necessary to be able to accurately evaluate the corporate financial results.

Following their 1991 study, Imhoff et al. (1993) argued that lease capitalisation yields an increase of debt to total assets ratio and stated, in their 1997 study, that lease capitalisation would, again, result in misleading ROA and return on equity (ROE). Beattie et al. (1998) supported these findings with their analysis of 232 U.K. corporations. Their conclusion was that lease capitalisation results in a significant difference on the profit margin, ROA, asset turnover and corporate gearing\(^{22}\). In addition to indicators, such as a debt to equity ratio, the current ratio is a frequently used factor to measure the liquidity of a corporation. This ratio measures the ability that a corporation has to repay current liabilities with its current assets. Bennet and Bradbury (2003) and Branswijck, Longueville and Everaert (2011) both added...
this current ratio to their study. Both studies emphasise the significantly higher debt to equity ratio and a lower ROA ratio and current ratio as a result of the lease capitalisation. Summarising these studies it can be stated that the capitalisation of off-balance sheet lease obligations results in a significant influence on a corporations’ financial ratios, with no change in the underlying cash flows or business activity. Table 2.5 shows the impact on the KPIs under the proposed dual accounting model, calculated by Tahtah and Spek (2012).

Table 2.5 illustrates the difference between the two approaches and clearly shows the lightened effect of the SLE approach. The differences can be assigned to the proposed guidance showed in table 2.1. The effects mainly concentrate on the income statement because of the required recognition of the amortisation of the ROU asset and interest component under the I&A approach, while the SLE method only requires a single line lease expense. Under the I&A approach, both the amortisation expense and interest expense are accounted for on a different place in the income statement and would, therefore, not affect the EBITDA\textsuperscript{22} ratio. As a consequence the EBITDA will increase.

One can argue that investors and credit rating agencies make adjustments for the off-balance sheet lease obligations, however Standard & Poor’s (2010, p. 5) emphasise the fact that “in some cases, the on-balance-sheet and income statement amounts that companies would report may differ significantly from our current adjustment, which also capitalizes lease obligations that are reported as operating.”. Thus, capitalising off-balance operating leases can have significant impacts.

Branswijck, Longeueville and Everaert (2011) indicate that the impacts will not be the same for all corporations because the impact will depend on the amount of operating lease commitments the corporation possess. The study of Tahtah and Spek (2012) supports this finding. They calculated the minimal impact on financial ratios of approximately 3.000 corporations worldwide. It is expected that the on-balance debt will increase with an average of 58% and corporations in the retail industry increase by an average of 213% (see table 2.6).

Table 2.6: Lease accounting impact per industry
Source: Adaption of Tahtah and Spek, 2012
The context of the percentages showed in table 2.6 is mentioned by Owendoff (2011, p. 18). He noticed that “According to the Securities and Exchange Commission, industry projections estimate over $1.3 trillion would be transferred to U.S. corporate balance sheets, with roughly 70 percent being in real estate leases.”. The European Federation of Leasing Company associations, Leaseurope, provide this information for Europe. Lückerath-Rovers (2007) analysed these numbers for the Dutch market. She argues that the numbers provided by Leaseurope are underestimated because the total amount of outstanding lease commitments in the Netherlands has a share of 11 billion Euros, while the obligations of exclusively operating leases for the examined 85 Dutch listed corporations already is 27 billion Euros (figure 2.8). Chapter 5 will go into further detail on the importance of and changes to KPIs.

2.3 CREM implications

This section addresses, in a random order, the most important changes that the proposed IFRS lease accounting guidance could have on the daily CREM practices of CREM divisions. These possible changes are all discussed considering the premise that all operating leases have to be capitalised on-balance. The capitalisation of the CRE operating leases will solely impact the corporate balance sheet because virtually all real estate leases will be recognised according to the SLE approach.

Rent

The capitalised value strongly depends on the amount of monthly rental payments that a lessee is obliged to make. This is often calculated by multiplying the amount of square metres to the square metre price. However, not all the rental payments have to be capitalised on-balance. One can discern, in light of the IFRS lease accounting project, fixed lease payments and variable lease payments (e.g., lease payments that depend on an index or a rate such as contingent rents). The latest discussions IAS 17 (2003, p. 8) defines contingent rent, that is commonly used in the retail industry, as: “Contingent rent is that portion of the lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time (e.g. percentage of future sales, amount of future use, future price indices, future market rates of interest).” Contingent rent formed a part of the variable payments, together with the base rent, that should be capitalised on-balance in the 2010 ED. However, the IASB and FASB tentatively decided in their February 2011 meeting to exclude these contingent rents from the minimum lease payments calculation and are charged as expenses in the periods in which they are incurred. This was because calculating the “probability-weighted average cash flows for a reasonable number of possible outcomes” (IFRS ED Leases 2010, p21), was considered to be very hard. For example, according to Nayer (2010, p. 4), who argues that: “Contingent rentals are often very hard to predict, especially as many contingent rental contracts are for many years. The necessity to estimate these amounts and revalue them on an ongoing basis will increase substantially the amount of work involved in lease accounting, without, in my opinion give additional relevant information to the users.” Contingent rents based on performance (e.g., a percentage of sales) or usage (e.g., number of kilometres flown) of the underlying asset would be recognised as an expense when incurred. For example, a contingent rent based on annual sales of a leased store would not be included in the ROU asset and liability to make lease payments recognised by the lessee. Instead, these payments would be recognised as an expense as the sales at the store occur. The decision to exclude performance and usage-based contingent rents from the amounts recognised on the balance sheet reduces the complexity of the proposed accounting for leases.

Residual value guarantees (RVGs) would also be included in the lease-related assets and liabilities at the amount expected to be payable (e.g., gross guaranteed amount minus the expected value of the underlying asset). For example, the lease agreement includes a guarantee by the lessee that the lessor will realise €10 million from selling the asset at the expiration of the lease. At lease commencement, the lessee estimates that the asset will have a value of €9 million at the end of the lease. Therefore, the lessee expects to pay the lessor €1 million under the RVG and includes this amount as a lease payment. Amounts payable under
guarantees provided by a third party would not be added to the lease payments. (Ernst & Young, 2010)

Discount rate
The discount rate is a very important factor used to discount cash flows (i.e., lease payments) to determine the Net Present Value (NPV), as note 19 explained. The discount rate takes into account the time value of money (the idea that money available now is worth more than the same amount of money available in the future because it could be earning interest) and the risk or uncertainty of the anticipated future cash flows (which might be less than expected). This is translated to a discount rate that consists of a risk free rate and a market risk premium, which will be discussed in more detail in chapter 5.

The discount rate is, thus, a very important variable because the calculated PV determines the ROU asset that is recognised and amortised on a straight line basis on the balance sheet. The discount rate is the rate the lessor charges the lessee (i.e., the yield on the real estate, also known as the Internal Rate of Return (IRR)) when that rate is known by the lessee, otherwise the lessee would use its incremental borrowing rate. The 2010 ED Leases (p. 47) states that: “The rate the lessor charges the lessee could be, for example the lessee’s incremental borrowing rate, the rate implicit in the lease (ie the rate that causes the sum of the present value of cash flows and the present value of the residual value of the underlying asset at the end of the lease to equal the fair value of the underlying asset) or, for property leases, the yield on the property.” The lessees’ incremental borrowing rate would be the rate of interest that the lessee would have to pay to borrow over a similar lease term, and with a similar security, the funds necessary to purchase a similar underlying asset (i.e., the corporate Weighted Average Cost of Capital (WACC)). Practically speaking, lessees will rarely know the rate (IRR) they are charged by the lessor and it varies quite significantly over time. In addition, cash-rich companies are likely more penalised by lease accounting because they have to discount all lease payments at lower discount rates than other companies. A higher discount rate results in a lower ROU asset (because of a larger discount of future payment obligations) but also a higher interest expense. The result is a higher total rent expense in the initial years and a lower expense during the later years to recognise on the income statement, contrary to a lease discounted at a lower rate. (Kranenburg, Kuin, Hardeveld, 2010). This implies that lessees will have the option to ‘search’ for the most profitable discount rate for each project, because not knowing the lessor’s implicit rate would permit the lessee to use its own WACC or, when more profitable, negotiate with the lessor to add their yield to the lease contract. (Ernst & Young, 2011)

The discount rate would, furthermore, not have to be reassessed for the whole lease term, it is possible that, in the case of changing circumstances in a lease contract, the lessee would need to restate the discount rate, for example, when a change in lease payments occur due to the lessee’s economic incentive to exercise a renewal option. This possible change in discount rates can, however, have a significant impact on the corporations’ financial statements and could affect various KPIs, as discussed in the previous section. (Canon & Fenbert, 2011)

Lease term
The lease term will be a key factor in the decision-making processes concerning IFRS lease accounting for CRE managers because, as section 2.2.2 showed, the lease term dictates besides the rent and discount rate the amount of the capitalised operating expenses. The lease term is defined, as stated before, by the IASB and FASB as: “the non-cancellable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a significant economic incentive for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease.”. This implies that CREM divisions have to reconsider their motives with entering future lease contracts in order to obtain a (new) balance between the capitalised payments within the lease term and additional renewal/break options, subleases and tacit renewed lease contracts. These economic factors are discussed in more detail below.
**Options**

Renewal options plays, as stated, a significant role in the calculation of the PV of the minimum lease payments because the longer the lease term, the higher the expenses that has to be accounted for. In the 2010 ED the IASB and FASB proposed to define the lease term as: “The lease term is defined as the longest possible term that is more likely than not to occur. (...)” This means that there should exist a greater than 50% probability to lease for a specified period. The IASB and FASB also re-deliberated this definition and tentatively agreed to include only optional periods for which there is a ‘significant economic incentive’ for the lessee to extend the lease. In this case a lessee has to define the non-cancellable lease term added with all options where there exists significant economic incentive to renew the lease in order to determine the lease term. Situations -i.e. contract-based, asset-based, and/or company-specific, not market-based- that may create an economic incentive for the lessee to exercise options are: very advantageous renewal prices (also called a bargain purchase option); penalty payments in the case of cancellation/non-renewal; and financial restraints such as significantly expensive customisations made to the real estate asset. (Ernst & Young, 2011)

One can imagine that these criteria may result in a ‘grey area’ when determining whether or not an option should be included in the lease term. This subjectivity may, again, provide opportunities for tailoring leases. Because CRE managers have to determine if, for example, the costs of the renovation of an office yield in a significant economic incentive to exercise the renewal option, or, if the new factory is interpreted as specialised of nature, which may be an incentive to exercise the renewal option. Another example: Assume a company enters into a lease for office space that includes a non-cancellable term of two years and two four-year renewal options. If there is no significant economic incentive for the company to exercise the renewal option, the lease term for accounting purposes would be two years. Now assume the lessee installed a significant amount of leasehold improvements at the beginning of the lease and the leasehold improvements have a useful life of ten years. The company may determine that a significant economic incentive exists through ten years. Therefore, it would conclude that the lease term for accounting purposes is ten years (see figure 2.4 for a recall).

Accounting for purchase options included in lease arrangements would be consistent with the accounting for options to extend a lease. That is, if the lessee has a significant economic incentive to exercise a purchase option, the exercise price would be included in the lease payments and the ROU asset would be amortised over the life of the underlying asset as opposed to the term of the lease. This also applies to break options; if the penalty is large enough (i.e., a significant economic incentive) to assure continuation of the lease then the whole lease term should be recognised on the corporate balance sheet. The termination payment would then be included as a lease payment.

Note that the corporation itself has to determine whether the ‘significant economic incentive’ is present. This is subsequently checked/verified by the accountant. This implies that the same lease design can be differently assessed by different companies with different accountants and the number of and the size of the renewal/break options are very important to scrutinise.

**Lease incentives**

Real estate leases know many kinds of different types of lease incentives. These incentives are often used by the lessor to enter the lease agreement. Incentives are, for example, rent-free periods, payments of the relocation costs by the lessor (such as moving expenses) or the takeover of the existing lease by the lessor with another lessee. All lease incentives will be deducted from the ROU asset but will not adjust the lease obligation. Incentives are, thus, being accounted for as ‘cuts’ in the amortisation expense over the lease term. This is not a new situation, because the recognition of lease incentives as a reduction of expenses over the lease term is in line with operating lease accounting to date. However, the balance sheet presentation is not the same. The IASB and FASB proposed with their dual model that an incentive represents a reduction in the costs of the ROU asset rather than being accounted for as a liability. Because the lease liability is not altered, the interest expenses will also remain the same. (Ernst & Young, 2011)
**Service contracts**

For future situations it may be desirable to be able to distinguish between contracts that contain lease and non-lease components, such as service costs and executory costs (e.g. insurance, maintenance and taxes), because service contracts will not have to be capitalised on-balance. When Lessees are able to ‘observe’ all (or parts of) the lease and non-lease components then they can determine which elements they have to capitalise on the corporate balance sheet. On the other hand, when payments between lease and non-lease components cannot be distinguished, lessees will have to recognise all the payments on-balance and measured using the proposed lease accounting standard. The IASB and FASB tentatively decided to provide guidance in the RED on how the ‘observable prices’ should be determined by lessees. This, thus, implies that separating service contracts from the lease contract can be profitable for the lessee because this service component will not have to be capitalised on the corporate balance sheet. This, for example, could be the case with triple net (NNN) leases. However, separating service components from lease contracts may cause difficulties, because many corporations may not have focused on separating them because the accounting guidance for these elements is often the same as the treatment for operating lease s. These companies would need to distinguish the prices for the lease and non-lease components in these lease arrangements. (Ernst & Young, 2011)

**Financing arrangements**

Roulac (2001) mentions that for many corporations, and recurrently for dynamic fast growing companies, CRE expenditures account for a substantial part of the capital budget. Because investments in CRE are so capital intensive, they must reflect the appropriate financing arrangement. Hermon (2005) and Bosma (2008) discuss the possibilities of financing CRE. Figures 2.17 and 2.18 illustrate seven financing arrangements that these studies, in line with Meulenberg (2006), argue to be the most important ones.

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23. A triple net lease (NNN) is a lease agreement on a property where the tenant or lessee agrees to pay all real estate taxes, building insurance, and maintenance on the property in addition to base rent expense.

24. Note that the actual financing process is subject to multiple internal and external factors and, thus, far more complex than discussed in this section. The scope is therefore limited to summarise the most important aspects of the financing arrangements that for CREM divisions.

Figure 2.16 demonstrates the seven most common financing arrangements according to the amount of control and value added. The control on the real estate asset increases when the financing arrangement is further located to the right on the horizontal axis. This is because of the fact that more influence is allocated with (external) actors and the dependency on these actors, thus, increases. The vertical axis shows the possibility to add value to the core business of the corporation. Bosma (2008) describes that according to Meulenberg (2006) the premise is that a corporation is able to earn a higher return from its core business activities than its investment in real estate. Thus, when a corporation invests in receiving the outright ownership of a real estate asset it is assumed that this is not as profitable as the capital was invested in the corporate core business. Or as Krumm and Linneman (2001, p. 5) stated: “The question corporations should be asking themselves is how can they destroy as little value as possible when investing in corporate real estate.”. Figure 2.17 shows that, according to the proposed lease accounting guidance, all real estate assets acquired with any financing arrangement will have to be recognised on-balance and the added value of Outsourcing, and Sale and rent may decrease because additional debt is added to the corporate balance sheet. Furthermore, the difference between SLB operating and SLB financing will lapse and it should,
thereby, be noted that SLB transactions are no longer applicable to provide off-balance sheet financing. Currently, IAS 17 determines if the leaseback is an operating lease or a finance lease and it does not require the seller/lessee to determine if the SLB transaction meets the sale-criteria. The IASB and FASB proposed to present SLB transactions as two separate transactions; a sale part and a leaseback part. In the new situation, however, it should first be determined whether the asset has been purchased or sold because if the asset is not sold to start with, the transaction would be accounted for as a finance lease by the seller/lessee. The recognition of a SLB transaction as a sale and a lease, or as a financing transaction, is based on meeting the requirements of a ‘sale’ (Ernst & Young, 2011). The IASB and FASB argue that a contract represents a purchase or sale of an underlying asset if: “At the end of the contract, an entity transfers to another entity control of the entire underlying asset and all but a trivial amount of the risks and benefits associated with the entire underlying asset. That determination is made at inception and is not subsequently reassessed. A contract normally transfers control of an underlying asset when the contract:
- Automatically transfers title to the underlying asset to the transferee at the end of the contract term; or
- Includes a bargain purchase option.” (IFRS, 2010, p. 45)

The IASB and FASB have, thereby, illustrated several other situations in the 2010 ED that are more specific and do not result in a purchase or sale. These situations may occur and are, therefore, good to mirror them to current corporate real estate SLB transactions. It is important to know if the transaction does (not) meet the sale-criteria because it has consequences for the guidance on the SLB transactions. For SLB transaction that resulted in a finance lease, however, nothing will change. A seller/lessee would not have to re-evaluate the sale-criteria, would not have to re-measure the on-balance assets and liabilities, and has to amortise any deferred gain, obtained from the sale of the asset, over the term of the lease in the income statement. Note that, thus, situations may occur that SLB transactions that previously did not meet the sale-criteria but under the proposed lease accounting rules do meet the criteria.

As stated, SLB transactions will no longer provide the option to keep the asset of the corporate balance sheet. This situation has to be considered by CREM divisions because SLB contracts that are entered today solely to keep the lease off-balance will no longer exist after the implementing the proposed IFRS lease accounting guidance and all leases under SLB contracts will, thus, appear on-balance and could impact the corporate KPIs as discussed in the previous section. With this in mind a ‘new’ lease approach, credit tenant lease (CTL) financing, for long-term leases should be considered. A CTL is a method of financing real estate. The landlord borrows money to finance the property and pledges as security the rents to be received from the tenant. Usually, the financing is structured as nonrecourse debt, and the lease is structured as a NNN lease. CTLs may be created either in SLB transactions, or new purchase transactions. This type of transaction may be considered for a build-to-suit, with the objective of reducing the developer profit. By pre-negotiating lease terms and arranging for a third party investor to purchase the property upon completion, the developer’s risk is reduced. The developer can reduce or eliminate their required equity contribution and therefore reduce the ultimate lease rate for the tenant. The decision point for a credit tenant lease is typically the level of risk and ownership characteristics the tenant is willing to accept. A credit tenant is usually a national, a large regional tenant or a local tenant with excellent credit that may be better than their national competitors, only larger companies are called credit tenants. A lender will offer better financing terms for a development with a certain amount of space preleased or currently leased to credit tenants. (Jones Lang LaSalle, 2010)

**Location**

By changing the location of the accommodation one can choose besides the provided operating decisions, for example, to decrease or increase to an ‘A’, ‘B’, or ‘C’ location, or to embrace a different tax rate when moving to another country. Changing the number of assets/reducing square metres can reduce the amount of operating expenses and is a ‘hot’ item since several years because of the implementation of Alternative Workplace Strategies (‘Het Nieuwe Werken’ in Dutch). Besides these location aspects are taxes an important issue to consider in the light of the IFRS lease accounting project. The corporate WACC is partly

25 A deferred gain occurs when a corporation makes a transaction that should result in a financial gain, but tax rules allow for a delay in payment. For example, if an owner has made a gain on a transaction, it does not have to pay taxes on this gain until the asset is sold.
dependent on the (corporate) tax level, chapter 5 will go into further detail concerning the corporate WACC. It should however be noted that tax levels differ per country. Thus choosing another country to locate a corporate office could mean other tax levels. It is not stated that tax levels will become a main driver for CREM divisions to change their decisions, but it is argued that it should be taken into account. Lückerath-Rovers (2012), for example, states that when two parties have different tax rates, they might find it worthwhile to shift possible tax advantages through an operating lease from the lower taxpaying entity (lessee) to the higher taxpaying entity (lessor). The lessor thus benefits from the tax incentives and may share these advantages with the lessee by means of lower lease rentals. The annual lease payments of operating leases are fully deductible from pre-tax income, whereas interest and depreciation can be deducted for capitalised lease obligations. Figure 4.2 showed that depreciation and interest in the early years of the asset exceed the annual lease payments (on annuity bases). This relationship is reversed in the last years of the lease term. It could, therefore, be argued that in the Netherlands the listed companies do not choose operating leases to shift tax shields from a low taxpaying entity to a high taxpaying entity. (Lückerath-Rovers, 2012)

Subleases
The 2010 ED Leases defines sublease as: “A transaction in which an underlying asset is released by the original lessee (or ‘intermediate lessor’) to a third party, and the lease agreement (or ‘head lease’) between the original lessor and lessee remains in effect.”. In a sublease arrangement, thus, one party will act as both the lessor and lessee of the same asset. That is, one party will obtain the right to use the underlying asset under the head lease, and it will act as the lessor in the sublease under which it conveys the right to use the underlying asset to a different party for the same or a shorter term. The leases are accounted for as separate transactions according to the proposed lessee accounting model (the assets and liabilities that arise in the head lease) and the proposed lessor accounting model (the assets and liabilities that arise in the sublease). It is important to note that besides renewal/break options subleases might create an economic incentive for the lessee. For example, a sublease term that extends beyond the non-cancellable period of the head lease (e.g., the head lease has a non-cancellable term of five years and a five-year renewal option and the sublease term is ten years). (Ernst & Young, 2011)

Notice that solely the most common situations with respect to real estate leases are discussed in this section. For a more in-depth view in the proposed lease accounting rules see the IFRS ED Leases (2010), released by the IASB. Table 2.3 summarises the most important CREM variables that would be affected by the proposed IFRS lease accounting rules. Chapter 4 will further discuss these operating decisions.

Table 2.3: Lease accounting associated operating decisions
2.4 Effective date: No time to waste

“As the financial crisis was caused by excessive leverage, our efforts to shed light on hidden leverage should be warmly welcomed around the world. The fact is that we are still facing an uphill battle. We will need all of the help we can get, to ensure that we do not get lobbied off course.”

(Hoogervorst, 2012)

The IASB and FASB agreed, and noted in the Memorandum of Understanding published in February 2006, to make a decision about the scope and timing of a the leasing project by 2008. The RED is now expected in the first quarter of 2013. The final standard was expected in the second half of 2012, but with the delays to the RED, as discussed in section 2.1.3, the final standard will also be delayed. It should be noted that there are still several outstanding issues to be resolved, and even the guidelines for which the IASB and FASB have reached a tentative decision could be substantially modified before the final standard is ultimately issued. However, the determination to finalise the project is causing rather delay than abandonment. The finalisation of the standard is targeted for Q4 of 2013. Figure 2.19 depicts the expected project time line of the lease accounting project.

The boards have not yet specified when the proposed lease accounting rules are implemented, called the ‘effective date’. The application process, however, is known. A corporation will have to apply the new standard to its annual financial statement for any fiscal year that begins after the effective date. This means, for example, if the effective date will be January 1, 2016 any fiscal year starting after that date would have to use the new accounting in its annual statement. Assuming that the corporate fiscal year begins on January 1, 2016, the financial statements for the year ending December 31, 2017 would be the first time that the corporation would report using the new standard. That sounds like a long time from now, but notice the fact that corporations will already have to collect and present comparable data of the year before the effective date (two prior years under U.S. GAAP). Considering an effective date of January 2016, the rules for the new standard will apply from January 2015. Subsequently, IFRS requires corporations to include results for multiple reporting periods in each report in order to recognise the differences between the ‘old’ and ‘new’ financial statements. For example, two balance sheets, income statements, statements of cash flows, and statements of shareholders’ equity have to be presented. This causes additional pressure to start the processes to collect the information and make the assumptions (such as for optional renewal periods) needed for these changes. Furthermore, as stated in section 2.2.1, grandfathering of existing leases is not allowed. Leases that are already in place today, as well as those, will be accounted for on-balance based on the remaining lease term on the effective date. The proposed lease accounting standard -even though it is not yet set- is, thus, for all existing leases and those signed between now and the effective date already in effect. Corporations should, therefore, already take the new accounting into account for setting strategy and making decisions, for example with the signing of new real estate leases. (PwC, 2010; Ernst & Young, 2011; Deloitte, 2012; KPMG, 2012)
2.5 Conclusion

The sub-question that has to be answered in this chapter is: “What are the key aspects of lease accounting and what are the key changes for lessee accounting with respect to CRE?”

Part of the IASB’s and FASB’s convergence agenda is the lease accounting project. The main concern of the lease accounting project is to provide transparency for the users of financial statements. This resulted in the proposal to recognise all leases on-balance, whereby the current difference between finance leases and operating leases disappears and a ROU asset and a lease liability are recognised on-balance. As a result, major changes occur with the changing way of preparing the financial statements. For lessees with large operating lease commitments, the impact of the changes will be significant; particularly the retail industry with large lease portfolios. With the added SLE approach for CRE leases the effect will not be as great as under the 2010 ED, however grossed-up balance sheets and the impacts on the KPIs can still be significant. Thereby, it should be noted that timely reassessment of the proposals’ impact on covenants and financing agreements will enable the start of discussions with banks, rating agencies and other users of the corporations’ financial statements because agreements based on KPIs such as leverage will require reassessment and potentially adjustment.

Where leasing, in particular operating leases, was seen as a good alternative to traditional financing because of its negligible impact on the corporations’ financial structure, which is positive for the borrowing capacity, these benefits will almost entirely be eliminated. Each time a lease is signed, rather than registering additional operating expenses, the corporate balance sheet will be impacted. This will alter the relationship between the corporate Chief Financial Officer (CFO) and CREM executives, because every time a lease occurs, the balance sheet will be impacted.

Application and implementation of the new lease accounting rules are, as it has become clear, a major challenge. It was expected that the new leasing standard would lead to a reduction of complexity and that the current situation would be replaced by only one accounting model. Although the final standard is not released yet, it can be argued that, despite the obtained transparency, it is questionable if the dual model would ultimately simplify current lease accounting. Depending on the lease classification, some leases would be presented as an SLE expense in the income statement while others would be presented separately as an I&A expense. In addition, the classification test would provide a new opportunity to structure leases because corporate specific judgement still plays a large role for leases that fall in a ‘grey area’ (hence the future bright-line test). A lessee, for example, may be able to account for its leases of similar underlying assets (e.g., two real estate assets) under both the SLE and the I&A approach. Therefore, managers could continue with searching for lease contract terms (e.g., contingent rents, lease incentives and renewal options) that minimise the balance sheet impact of the proposed lease capitalisation. The most important variables that can be altered by CREM divisions are illustrated in table 2.4.

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<th>Operating decision</th>
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<td>Rent</td>
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<td>Contingent rent</td>
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<td>Annual rent</td>
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<td>Square metres</td>
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<tr>
<td>Lease term</td>
<td>Purchase option</td>
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<td>Discount rate</td>
<td>Amount of renewal options</td>
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<td>Lease incentives</td>
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<td>Location</td>
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<td>Subleases</td>
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Table 2.4: Lease accounting associated operating decisions
In addition, structuring opportunities through SLB transactions are expected to be significantly reduced when the final lease accounting standard is applied. This causes CRE managers to implement changes with respect to data management, transaction management and portfolio decision-making.

Corporations should, since the final ED is expected to be released in 2016, begin planning as early as possible to address necessary changes in collecting and validating the needed lease information, supporting business and accounting processes, and integrating with new or upgraded technology systems.
IFRS lease accounting impact on Corporate Real Estate Management
Corporate real estate strategy

This chapter provides an overview of CRE strategies and the implementation process of those strategies. In addition, this chapter emphasises the background and the role of CREM within the corporation. Before going into detail towards CRE strategies the term strategy will be explained (§3.1), the CRE strategies will be provided (§3.2), the emergence of CREM will be discussed (§3.3) and subsequently the role of performance is evaluated (§3.5). The final section of this chapter (§3.5) will answer sub-question 2: “Which CRE strategies can be distinguished and what are their added values in a corporate perspective?”

3.1 Strategy

“The dirty little secret of the strategy industry is that it doesn’t have any theory of strategy creation.”

(Hamal, cited in Mintzberg, Ahlstrans, Bruce, & Lampel, 1998, p. 115)

CRE strategies are only effective when they are in full alignment with the overall corporate business strategy (Nourse & Roulac, 1993; Krumm, 1999; Scheffer, Singer & Van Meerwijk, 2006). Strategy however, is a subjective element that knows a wide spread of definitions and perspectives of thoughts. This makes alignment of multiple strategies a complex matter. Although business strategies are not the main field of interest of this thesis, it is desirable to discuss these business strategies because it is hard to fathom CRE strategies without an understanding of the overall business strategy.

The noun ‘strategy’ knows a long history. It was first used within Roman military context 400 years B.C. (Mintzberg, Ahlstrans, Bruce, & Lampel, 1998). During the centuries it developed and evolved to broader context. It was not until the 60’s when strategy was first used in business context. The three prescriptive schools: “planning, design and positioning school” formed the fundamentals in strategy thinking and are the most dominant within corporate practice as within the research field. Where some of these schools are already outdated and others are in a decline (Figure 3.1) it is good to understand there is no ultimate answer to the question which one is the right one. After all, each strategy has postive and negative effects and a conjunction will lead to the right strategic management. (Mintzberg et al., 1998)

![Figure 3.1: The three prescriptive schools](source: Mintzberg et al. (1998))

The essence and evolution of the three prescriptive schools will be briefly described whereupon a conjunction is made of general terms of agreement in order to understand the noun ‘strategy’.
In the 60’s the design school presented a basic business strategy framework that seeks to attain a match between internal competencies and external elements. This basic framework formed the base for further strategic schools of thought and is widely known as the SWOT analysis. One of the pioneers of the design school described strategy as; “Strategy will be seen as the match between qualifications and opportunity that positions a firm in its environment” (Christensen, Andrews, Bower, & Hamermesh, 1982, p. 164). According to Mintzberg et al. (2008) the design school is restricted and primitive in the implementation. It is best applicable when a major shift in external and internal aspects occurs and the existing strategy is seriously undermined. Another context where the design school may be relevant is for start-up organisations to determine a clear sense and direction. Despite this criticism the SWOT model and thereby the design school is still the main centerpiece for one of the main essences of business strategy, namely the fundamental fit between external opportunutities and internal capability.

Synchronous with the existence of the design school, mass-production had its introduction and long-term planning became a second essence in strategic management. Through scenario planning the future demand for products is determined and a competitive advantage is created. First, strategy goals are set out whereupon external and internal conditions are assessed. Additive to the design school strict goals on the front end and operating plans supplemented with budgeting targets at the back end, are set out as part of the strategic plan. In contradiction to thinking in values, as within the design school, strategic planning is in practice not much more than quantification of the goals as means of control. Once the goals are set out, external and internal conditions of the corporation are assessed. Thereby, the external environmental forecast forms the cornerstone within the strategic planning school. The external forecasting is based on the assumption that economic, social, political, technological and competitive change is taking place and can be forecasted by planners and thereby could control the future. ‘Predict and prepare’ (Ackoff, 1983, p. 59) became the essence of the planning school.

The publication of “competitive advantage” by Porter (1980) caused a transition point in strategy thinking. This ‘one’ publication caused a discussion about the essence of strategic planning and increased the demand for more in-depth studies. Long-term planning was replaced for a competitive market position. Where from a planning perspective the conception is you create the market, the positioning school suggests you should choose a competitive position within the market. More seriously stated, only strategies that create a position within a market and strategies that can defend this position against competitors are desirable. Both earlier described planning and design schools put no limits towards strategy formulation and even emphasise each strategy is unique and tailor made for a specific organisation. In contradiction Porter (1985) argues there are two just sorts of competitive advantages; costs and differentiation- which are incorporated within four generic strategies; cost leadership, differentiation, cost focus and differentiation focus. Cost leadership aims on being the lowest cost producer of a product or service. Differentiation strategies are focused on unique products with higher quality. These strategies can be differentiated by focussing on a particular segment or geographical scope (niche). For ‘differentiation focus’ this results in adapted product offerings to a specific focal market and for ‘cost focus’ this means lowest cost leadership within a focal market. These focus strategies allows corporates to concentrate and develop specific competences and knowledge that creates a competitive advantage as well. This complements the amount of strategies to the total of four. How effectively corporations implement one of these strategies determines the competitive advantage and subsequently the added value. Herewith it is crucial to take a position; “a firm that engages in each generic strategy but fails to achieve any of them is ‘stuck in the middle’” (Mintzberg et al., 1998, p. 106).

According to Porter (1985), competitive advantage is primarily a consequence of choosing one of the generic strategies. Porter (1985) emphasises that competitive advantage cannot be understood without inventory of the corporation as a whole. The value chain (figure 3.2) visualises this concept, whereby value contribution of corporate activities and
resources is subdivided in support and primary activities. The value chain allocates corporate resources and indicates how activities in a corporation interact with each other.

Thereafter it derives to what extent the corporate resources are accountable for the added value of the total chain. Management of the primary and supportive activities is crucial but the management of total chain should be considered as most valuable. Summarising; the better the total chain is aligned and managed, the more the competitive advantage will increase, and the larger the margin and thereby the added value in theory will be.

CRE is initially not part of the original Porter chain, but if CRE is reflected as a fifth business resource as argued by Joroff et al. (1993), CRE deserves a prominent place among the supportive activities. In figure 3.2 CRE is added to the original value chain of Porter, herewith it becomes apparent that corporate strategies do not reach their full potential when it is poorly aligned with CRE strategies as with the remaining part of the value chain.

The described prescriptive schools rely all on hard data in order to structure the strategy formulation by models and analytical techniques. Strategic management therefore, tends to be described as strict elements of formulation, implementation and control which have to be followed in this strict sequence (Meijer, 2011). However, ‘strategy’ is not a trick that can be applied for each corporate again and again. The six descriptive schools prescribe, in a lesser extent, a strict framework for strategy formulation. In contradiction these schools emphasise the strategy implementation process. As Hamel stated: “The dirty little secret of the strategy industry is that it doesn’t have any theory of strategy creation” (Hamel, cited in Mintzberg et al., 1998, p. 115) which stresses that models do not create strategies but visions of people do. Nevertheless the prescriptive schools still form the mayor foothold in strategy formulation for corporations today. Despite the wide variety within these prescriptive schools there are numerous terms of agreement, which combined give a good understanding of what ‘strategy’ is about. (Meijer, 2011)

- Environment: Strategy concerns both organisation and environment. Corporations use strategy to deal with existing and changing environments. Analysing and forecasting of internal and external parameters is essential.
- Continuing process: The substance of strategy is complex. Changes are in certain matter unpredictable and occur in various combinations. Strategies are unstructured, non-routine and strategy formulation is a continuing process. (Mintzberg et al., 1998)
- Performance: Strategy decisions are considered to be that important that it affects the welfare of a corporate and are thereby directly related to the overall corporate performance. (Meijer, 2011)
- Alignment: Strategies are implemented on certain levels within a corporation. The overall corporate strategy forms the objectives for supportive strategy formulation in
order to realise the strategies full potential. CRE strategy should therefore be a derivative from the overall corporate strategy.

- Formulation: Strategy formulation involves both conceptual as analytical skills. The distribution of those will vary from corporate to corporate. (Meijer, 2011)

3.1.1 Strategy context
As mentioned before the internal and external environment also known as the ‘strategic context’ is essential within the strategy formulation process. A corporation can be seen as an open system which can be influenced by the contextual environment and vice versa. Strategy design is based on this contextual environment and needs to be reassessed within a certain time span since the contextual environment evolves in time. It is up to strategy policy makers to set up strategies that anticipate on this changing context in order to retain strategic goals. Providing regular updates is thereby essential within strategy design. The organisational context is business specific and unique for each corporation. Changes in structure, culture or outset goals of a corporate could affect the strategy process or be a reason to reassess the current strategy. Besides the organisational context there is a general context. De Vries (2007) distinguishes the general context within in four exogenous elements: law & regulations, social development, market developments and demographic developments. These aspects are identical for each AEX corporation who participates in the Dutch geographical market. Changes in one of these aspects could, according to De Vries (2007), influence the strategy design or be a motive to reassess the strategy policy. In figure 3.3 the ‘law & regulations’ box is marked dark green to emphasise that this is the box where the new IFRS lease accounting regulations impacts the general contextual environment.

3.2 Corporate real estate strategies

“The realization by corporate real estate managers; that their business is not real estate, but the business of the business”

(Nourse & Roulac, 1993 p. 29)

Before going into further detail on specific CRE strategies it is important to define CRE. Within the literature a variety of CRE definitions can be found, which evolved from time to time. Most of those definitions are a derivative of the following definition developed by Zeckhauser and Silverman, (1983) who where the first to explore the world of CRE:

“The land and buildings owned by companies not primarily in the real estate business”

(Zeckhauser & Silverman, 1983, p. 111)

Other studies made this definition more delineated. Rodriguez and Sirmans (1996) argue there is no discrepancy between investment real estate and CRE, as there should be no difference in how real estate is evaluated within the framework of a corporate strategic plan. However, many studies contradict this statement by emphasising the disparities between these two types of real estate (Nourse & Roulac, 1993; Joroff et al., 1993). According to
Roulac and Manning (1999), CRE is used by corporations for business objectives and can be considered as an input in the production process (business resource), while real estate investment is using capital investment into properties and expecting capital gains from the transactions. Nappi-Choulet, Missonier-Piera, and Cancel (2009) support this perspective and delineated the definition which comprehended all elements of CRE. Their definition will be used as the guiding definition of CRE within this thesis.

“CRE is defined as corporate property – industrial, office and retail space – used for business purposes, as an input into the production process by companies not primarily in the real estate business.” (Nappi-Choulet, Missonier-Piera, & Cancel, 2009, p. 80)

CRE has primarily the function to accommodate and support the core business activities. Thereafter, Meijer (2011) and Ramakers (2008) mention four other functions which can be categorised as follows:

- Utilisation function (accommodate people and business process)
- Technical function (safety, wind- and waterproof)
- Financial function (allocate and manage CRE within the financial boundaries of the organisation)
- Symbolic function (contribute added value due to marketing and cultural expression)

Since its origination, two centuries ago, CRE is one of the largest asset classes in the world. But it was either until the 80’s that researchers began to call attention to the largely unrecognised importance of CRE (Roulac, 2001). Zeckhauser and Silverman (1983) were the first who raised scientific attention to this neglected corporate resource. They concluded that CRE represented 25% to 41% of the total corporate assets and urged corporate America to reinvent their CRE in order to increase the corporations’ value. This eye-opener urged corporations for the first time to think about the allocation of their (financial) resources in terms of CRE assets (Krumm, 1999). Despite these findings, Nourse and Roulac (1993) concluded that CRE was still not present on the senior management agenda. CRE was still seen as a necessary burden of bricks and stones which obligated companies with large capital spendings for relative large periods of time in order to produce profitable products. (Dewulf, Krumm, & De Jonge, 2000; Brounen & Eichholtz, 2005). Most boards of executives treated property as an overhead cost like stationery and paper clips. Senior management justifies this lack of interests with the familiar statement; “We are not in real estate business”. (Zeckhauser & Silverman, 1983)

Corporate strategies are meanwhile commonplace either specific CRE strategies are still exceptional. This is caused by the historically focus of corporates to the utilisation function of CRE. Real estate decisions were made on property to property basis without a strategic driver- let alone in consideration with other supportive activities. The most strategic intention was to manage CRE as a cost reduction or profit centre. Seniors’ management hardly recognized CRE as a corporate resource that had the potential to contribute in organisational or economic added value context (Krumm, 1999). During the last decade the attention of corporates and academics grew and CRE finally evolved to a corporate resource that has the potential to strengthen the overall competitive advantage. Simultaneously the amount of research related to strategy alignment in relation to CRE grew sufficient. This is not surprising since alignment, as mentioned in (§3.1), is one of the crucial aspects in strategy formation.

Ramakers (2008) compared eight journal studies about alignment and distilled seven distinctive CRE strategies. She concluded that despite the vast majority of the corporate business strategy theories just four of the eight studies used previous studies for the definition of the corporate business strategy. Three studies defined their own corporate business strategies and one did not define a corporate strategy at all. She argues that the great difference between are principles used to determine the overall corporate strategy. Although Ramakers (2008) traced the sources that were used for determining the overall corporate strategy she lacks in making the link with the overall management school of the used models. In the following table 3.1 this link is made and in addition an explanation is made why the used theory can be categorised to a particular management school.
Table 3.1: Strategy theories linked to strategy schools

If this link is made, the conclusion is that three out of four studies that used previous studies are related to the positioning school of thought. And one can be traced back to the planning school. From this perspective the principles that are used are not as diverse as Ramakers (2008) suggested. Respected the dominant characteristic of the positioning school it is not surprising, but it emphasises the immaturity of this research field.

From CRE strategy perspective, Nourse and Roulac (1993) were the first who defined eight different real estate strategies and investigated one of the essence of strategy; the strategy alignment. Their work formed the basis for many other researchers in the field and was by Ramakers (2008) considered as one of the most useful ones in formulating and aligning CRE strategies. Nourse and Roulac (1993) used the driving forces methodology of Tregoe and Zimmerman (1980) for determining the corporate strategy, whereupon eight alternative CRE strategies were formulated.

Tregoe and Zimmerman (1980) argue that driving forces form the fundamental basis that can be used as a clear and simple concept to guide top management in developing the strategic framework. Stated that all nine driving forces are important to the core business, only one primary force is determining the business strategy. Nourse and Roulac (1993) therefore formulated eight alternative CRE strategies. The formulated CRE strategies are thereby a direct derivative of the corporate business strategy (figure 3.4).
“The primary determiner of the scope of future products and markets is the organization’s driving force, which in turn provides the basis for defining the other choices in the strategic profile” (Tregoe & Zimmerman, 1980)

Just as it is inappropriate to specify a corporation’s CRE strategy without consideration of the core business strategy, so is it inappropriate to make a particular real estate decision without considering the CRE strategy. Therefore Nourse and Roulac (1993) introduced besides, eight alternative real estate strategies, fourteen real estate operating decisions (figure 3.4). These operating decisions are applicable every time a real estate decision is made, either through implementation of the transaction or as an implicit decision not to implement. Within some real estate strategies some implementation decisions will be more dominant than others, where should be noted that all real estate implementations decisions have to be assessed independent which CRE strategy to follow. Chapter 4 goes in to further detail regarding these real estate implementation/portfolio decisions.

Figure 3.4: Linkage between driving forces, CRE strategies and implementation decisions
Source: Nourse and Roulac (1993)

CRE strategies are eventually implemented to add value to the core business and strengthen the competitive advantage. Added values can be divided in two sorts; exchange value and use value (Appel-Meulenbroek, n.d.). Exchange value is focused on a cost perspective and is in full control of the CRE manager. The use value strategies need an interaction with other business units as human resources, technology or marketing and sales in order to generate a successful added use value. CREM’s impact on the output performance with use values is indirect (Appel-Meulenbroek, n.d.). By means of the review from Ramakers (2008), De Vries (2007) and Nourse and Roulac (1993) a list of seven real estate strategies is constituted which are subdivided in exchange / use value strategies and are linked to the four overall strategies provided by Porter.

<table>
<thead>
<tr>
<th>Corporate strategy</th>
<th>Real estate strategy</th>
<th>Added Value</th>
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<table>
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<tr>
<th>Lowest costs</th>
<th>Reducing costs</th>
<th>Exchange value</th>
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<tbody>
<tr>
<td>Focus on lowest costs</td>
<td>Increasing the value of the asset</td>
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<td></td>
<td>Increasing flexibility</td>
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<tr>
<th>Differentiation</th>
<th>Increasing innovation</th>
<th>Added use value</th>
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<td>Differentation focus</td>
<td>Increasing employee satisfaction</td>
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<td></td>
<td>Increase productivity</td>
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<td></td>
<td>Increase promoting, marketing and sales</td>
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Table 3.2: Strategy linked to value
Chapter 2 discussed that the proposed IFRS lease accounting issues have mainly financial impacts, thus, it can only affect financial related strategies. The description of the different strategies therefore will be demarked by the exchange value strategies.

**Cost minimisation**
It is important to distinguish the difference between being cost effective and seeking the lowest costs. All decisions should be cost effective for the quality of space sought, but this strategy emphasises the search for the lowest cost decision (Nourse & Roulac, 1993). The most actions conducted by corporations to act upon this strategy is to outsource some real estate services, co-locate business units, making more efficient workplaces, choosing locations based on governmental incentives, reduce expenses by negotiating lower rents and increase quality and timing of maintenance to avoid costly repairs and capital expenditures (Lindholm, Gibler & Leväinen, 2006).

**Increasing value**
Increasing the value through managing the real estate portfolio, views real property as a capital asset, that can be managed to insure an optimal financial contribution to the corporation (Lindholm, Gibler & Leväinen, 2006). By timely disposal and acquisition of real estate, marketable buildings, knowledge and insight into real estate markets and redevelopment, real estate can make this contribution (Krumm & De Vries, 2003; Scheffer, Singer & Van Meerwijk, 2006).

**Increasing flexibility**
A strategy of increasing flexibility may include both physical workspace and financial terms. Real estate must accommodate changing organisational space requirements and favour facilities that can easily be adapted to multiple uses by corporations and others (Nourse & Roulac, 1993). Designing more flexibility into buildings can also make it less costly to renovate and expand the original building for new use within the business or to sell it at a more favourable price when surplus, thus reducing occupancy cost over the long run (Nourse & Roulac, 1993). Some operating decisions that would follow from a flexible real estate strategy include choosing spaces that can be adapted to multiple uses and workers, creating flexible workspaces within the structures, negotiating short-term leases that include options for expansion and contraction, and leasing rather than purchasing properties that are not essential to the core business (Lindholm, Gibler & Leväinen, 2006).

3.3 Managing the fifth resource

“For many organisations property only becomes an item on senior management’s agenda when a significant crisis looms on the horizon.”

(McDonagh & Nichols, 2009)

During the decades CRE divisions have grown and managing CRE has become a professional discipline. At almost every organisation CREM practices have evolved from a narrow definition focusing on managing, acquisition and disposal, of real estate to managing a wide range of functions that support internal and external corporate factors. These focus areas are illustrated in figure 3.5. (Dewulf, Krumm, & De Jonge, 2000)
Krumm, Dewulf and De Jonge (2000) provided the following definition of CREM:

“The management of a corporation’s real estate portfolio by aligning the portfolio and services to the needs of the core business (processes), in order to obtain maximum added value for the businesses and to contribute optimally to the overall performance of the corporation.” (Dewulf, Krumm, & De Jonge, 2000, p. 32)

Krumm, Dewulf and De Jonge (2000) describe that CRE holdings were merely a necessity for corporations to operate thirty years ago. In the absence of a well-developed commercial rental market, there were little alternatives to developing or buying corporate real estate. Hence, corporate growth would automatically result in obtaining a portfolio of land and property, which could result in a significant part of the balance sheet (Brounen, Verschoor, & Würdemann, 2012). The question how to manage these CRE portfolios has long been a consideration that was not contemplated. In fact, the views on CRE management, both from professionals and within science, have evolved only gradually over time. This evolution of views on how to deal with CRE needs exhibits according to Brounen et al. (2012) strong resemblance with the Kübler-Ross (1969) model, which describes five stages of a process on how people deal with personal grief; denial, anger, bargaining, depression, and acceptance. The five stages of the Kübler-Ross model are used as a template to describe the evolution process of CREM by Brounen et al. (2012) as follows:

I. Denial
In 1983, Zeckhauser and Silverman offered convincing Harvard survey evidence, which showed that 60% of American companies was simply not evaluating the value and performance of their real estate assets. They treated property as an overhead cost like stationery and paper clips.

II. Anger
The rediscovery of real estate holdings on their balance sheet inspired corporations to regard it as means of cutting costs. Managers were shocked by the amounts that these holdings represented and horrified by the incidents where this undermanaged and undervalued balance sheets item attracted hostile takeover bids.

III. Bargaining
After the rediscovery and consequent cutbacks, a new wave of opinions emerged. CRE started to become a strategic element, and was soon referred to as ‘the fifth business resource’, after capital, human resources, technology and information. Having the proper real estate facilities enhanced productivity and could strengthen the corporation.

IV. Depression
In this phase, corporations start to sell of their CRE assets, often by means of sale-lease-backs to free up cash when liquidity is constraint. Salvaging the corporation swiftly emerges as number one concern, which often degrades the CRE portfolio to a rescue capsule that need to be floated.

V. Acceptance
The final stage of CREM is one of overview, with which corporations’ trade-off all the advantages and risks that associate their property holdings. Here, financial and strategic considerations can melt into a sustainable state of mind, in which CRE needs are serviced adequately and contribute to the corporation’s mission and valuation.
In resemblance with Appel-Meulenbroek (n.d.) and Gibler and Lindholm (2012) Brounen et al. (2012) also mention that although the literature on CREM has come a long way during the past thirty years, not all corporations have reached the acceptance phase. “Surely, a lot has changed from the time of the call for rediscovery by Zeckhauser and Silverman in 1983. Most corporations have employed specialised CRE managers, and have positioned CRE departments that often report directly to the board. There is no more ‘denial’ in corporate boardrooms when it comes to their real estate needs. However, it cannot be claimed that enough is communicated by corporate management about their portion of corporate value to claim the status of ‘acceptance’ stage V. This, however, will change with the issuance of the proposed IFRS lease accounting guidance.” (Brounen et al., 2012, p. 2)

The CREM division is imposed by implementing the objectives of the users as representing the corporation by maximising the value for the shareholder. Maximising the value is not necessarily a financial return on the real estate assets but moreover the return to the core business. This return to the core business is also known as the added value of CRE. CREM is a continuing balance between the interests of the corporation and those of the business units. Balancing these interests requires a wide spectrum of competences on all sorts of business levels, varying from acquisition to disposition and from tactical to strategic level. (Dewulf, Krumm, & De Jonge, 2000)

Several authors tried to visualise this field of tension and the corresponding activities. De Jonge, (1997) presented a framework that distinguished four elements of CREM:

- General management represents the corporate goals, concerning long-term continuity and profit. (corporate perspective on strategic level)
- Asset management reviews the financial opportunities and concerns the constant deliberation of allocating financial resources into corporates core business or investing in real estate. (real estate perspective on strategic level)
- Cost control orientation focuses on controlling the expenses and commenting the financial targets. (corporate perspective on operational level)
- Facility management. The day to day needs and support for the corporate core business needs are central. (real estate perspective on operational level)

These four elements are illustrated in figure 3.6.

![Figure 3.6: CREM](source: Dewulf, Krumm, & De Jonge, 2000)

3.3.1 The evolution of corporate real estate management

Nourse and Roulac (1993) describe five timeframes in the evolution of CREM. The era before 1970, is known as the custodial period where real estate was emphasised as a production resource. The management focus was on maintaining and constructing the facilities and real estate decisions were made on property by property basis. During the entrepreneurial timeframe some corporations perceive the potential financial gains and took advantage of the real estate opportunities. Within some corporations, real estate functioned as a real estate investment business line separate from the corporate core business. They competed directly
with the real estate business. For the large part of those real estate initiatives making profit was their primarily goal, meeting the corporation’s spatial needs was made secondary. During the restructuring in the early 90’s business units not related to the core business were eliminated. The real estate portfolios where downsized and the management focus were efficiency and cost reduction. Within the subsequent managerial period effectiveness was leading, outsourcing was a new trend to create efficiency, accommodate growth, clear balance sheets and improve performance ratios; solvability and liquidity. The last decade can be seen as the strategic era where CREM exceeds concerns about: growth, cost efficiency and effectiveness. CRE is eventually seen as a resource which can contribute to the corporation’s strategic goals to create a competitive advantage. (Roulac, 2001)

Where Roulac (2001) describes the evolution of CREM in timeframes Joroff, Louargand, Lambert, and Becker (1993) identified the widely recognised five evolutionary stages of CREM unit development: taskmaster, controller, dealmaker, entrepreneur and business strategist (figure 3.7). Each step forward within in the evolution diagram results in; more value added by the CRE to the core business, evolving benefits from short-term to long-term and bringing CRE closer to the senior corporate management board.

Each higher level on the CREM ladder is, according to Joroff et al. (1993), the path to a more mature CREM division. The phase where an organisation is in is an indicator for the added value delivered by CRE to the overall core business. The first two stages on the ladder are solely focused on the internal needs of a corporation and are operational orientated. These user driven CREM divisions are historically more driven by design and construction management and have a decentralised role at the business unit level because the need of interaction with the users. By creating more horizontal synergy between business units the tactical level is reached. CREM departments within this stage are proactive in meeting the business unit’s needs.

Within the strategic level vertical synergy is implemented, thereby competencies that contribute to the overall business strategy have to be reflected to other divisions. Other stated the CREM division should be in full alignment with the overall corporate strategy. (Krumm, 1999).

The Joroff-model is used within several studies and during the time slightly changed. The following brief description per phase is an alignment of studies; (Joroff et al., 1993; Dewulf, Krumm & De Jonge, 2000; Krumm, 1999; Ramakers, 2008). Thereby is intended to replenish the description per phase.
I. Taskmaster
This level of real estate executives is focused on the internal physical space demand and maintaining the quality of it. They are technical focused on the operational needs. The real estate department has too little attention from senior level and has no financial benchmarks to align with. The added value of CRE in this stage is status quo.

II. Controller
The controller is like the taskmaster still focused in the operational day to day needs by delivering the physical space and maintaining the quality of it. Besides the technical support the controller is capable in financially benchmarking the CRE. Their overall mission states; support the space needs of the business units to the lowest costs as possible, and the ability to shift accountability. The senior management recognises the potential benefits and costs, never the less the added value neither pursues cost reduction.

III. Dealmaker
CREM departments in this level become proactive in problem solving on behalf of the business unit real estate demand. They are continuously active with aligning the organisational needs with optimal real estate solution by standardising building usage across the company. The dealmaker benchmarks their performance with financial as operational performance as the products they deliver.

IV. Entrepreneurs
In this stage the real estate business unit becomes an independent business line and business units become customers. Business units rent directly from the CRE department and pay market rents for their occupied space. The CRE department becomes a real estate company that acts like a developer. Decision-making no longer consists of a property to property basis but on portfolio level. Where real estate is a part of strategic planning within other business units this kind of CRE division is actively involved consulting and providing data. The added value consists besides the active coordination with other departments out of realising a profit. The entrepreneur usually gains regular access to the CFO and thereby grew to a serious agenda point of the board.

V. Business strategist
The business strategist is closely aligned with the board of directors and is finally seen as a fifth resource that can compute to the competitive advantage of the corporate business. The unit’s mission is no longer simply providing real estate but strengthen the corporations’ strategic advantage and stakeholders’ value. Value is added by anticipating on business trends, monitoring and measuring their impact and contributing to the direction and competitive advantage of the corporation as a whole.

“The realization by corporate real estate mangers; that their business is no real estate, but the business of the business.” (Nourse & Roulac, 1993)

This sequence recognises the need for real estate executives to move from order taking to tackling corporation-wide competitive issues (Ramakers, 2008). Despite this statement, there is not a right or wrong stage within the ladder. Nor must a CRE division acquire all skills consequently. Situations differ from corporation to corporation. CRE divisions have to recognise whether their current phase meets the overall corporate goals and needs. (Joroff et al., 1993)

Evolution on the ‘ladder’ is subjected to a few pre-conditions:
- Skill requirements are levelled up and cannot be abandoned in later phases.
- The phases are all focus driven; each linked to a mission and fully depended on the competence of human capital and the correct involvement of the different stakeholders.

Mattouch (2010) argues that Joroff et al. (1993) mention the fact that when a CRE division rises on the ladder this has significant impact on the organisation, but he renounced in giving evident success factors that cause this particular evolution. Thereby the practical implantation is limited (Mattouch, 2010). In addition Mattouch (2010) combined the visualisation by Van Driel (1998), and Dewulf, Krumm, & De Jonge (2000) and the Joroff ladder to an overall figure, figure 3.8, that encompasses the total field of tension of CREM within the different strategic levels. The evolution from short to long term horizon and from operational level to board-room is added to the original figure of Matthoush.
From the corporate perspective and the real estate perspective the different competences and strategic levels can be subdivided in strategic, tactical and operational level. On strategic level the CRE strategy is supportive to the core business through the constant deliberation of allocation and aligning (financial) resources into the core business. On a tactical level the structure of business units is determined and the strategic real estate plan is operationalized from property to property basis concerning user’s interests (business units). The last stage is the operational level where day to day needs are provided. (Mattousch, 2010; Dewulf, Krumm, & De Jonge, 2000)

Thus, CRE operations should be able to answer to core businesses’ space demand, which means that successful CRE strategies are the ones that are aligned with the corporate core business. Nourse and Roulac (1993) argue that CRE strategies can only be effective when they are in full alignment and supportive to the corporate strategy.

3.4 Performance indicators of CRE

“The only reason an organization has a strategy is to deliver value to stakeholders”

(Neely, Adams, & Crowe, 2001, p. 6)

As mentioned in §3.1 strategy decisions are considered to be that important that it affects the performance of a corporation. Main objective for an organisation is to strive for continuity. This is only feasibly with a positive financial result on the long term (De Vries, 2007). Financial results are common related to the concept of performance. However, performance consists of more than solely financial results.

Because of the diversified amount of stakeholders which each have a unique perspectives and interests, performance measurement is not solely financially driven. Neely et al.(2001) identified five perspectives in relation to performance measurement.

- **Stakeholder’s satisfaction.** Who are the stakeholders and what do they want and need?
- **Strategies.** What are the strategies we require to ensure the want and needs of our stakeholders?
- **Processes.** What are the processes we have to put in place in order to allow our strategies to be delivered?
- **Capabilities.** What are the capabilities we require to operate our processes?
- **Stakeholder contribution.** What do we want and need from stakeholders to maintain and develop those capabilities?

In perspective of §3.1 processes and capabilities can be considered as the management of the total value chain of Porter. In addition stakeholders’ contribution and satisfaction can be combined as one element. This reduces the list of five to three. Subsequently these elements can be subdivided in internal and external performance measurement perspectives. Where the internal performance measurements have the main purpose to evaluate and control if the implemented strategies meet the goals. These goals are driven by the external performance measurements which are determined by external stakeholder.

**External**
- **Stakeholders.** Who are the stakeholders and what do they want, need and contribute?

**Internal**
- **Strategies.** What are the strategies we require to ensure the wants and needs of our stakeholders?
- **Value chain.** How do we need to manage the total value chain of human resources, information, technology, capital and CRE in order to meet our strategies?

Organisation and CRE performance can be expressed in multiple factors as; productivity, performance, profitability, efficiency, effectiveness etc.. Tangen (2005) developed the triple p-model (figure 3.9) based on thirty years of previous research. This triple-p model forms a management tool to translate (CRE) strategies toward (CRE) goals. The core of the triple-p model is formed by; productivity, which encompasses the straightforward relation between output quantity (products / services) and the input quantity (resources that are consumed to produce the product / services). Tangen (2005) argues that productivity is a physical phenomenon which is hard to quantify and therefore must be seen as one element. Profitability is also an interaction between input and output but in terms of money as a shared quantification. Corporate performance forms the umbrella that includes; profitability, productivity, and distinctive characteristics as quality, delivery, speed and flexibility which is related to the market share of a corporation. The terms effectiveness and efficiency are applicable for all value measurements and are common used to benchmark internal strategy goals. (Tangen, 2005)

![Figure 3.9: Performance measurement](source: Tangen (2005))

This triple P-model can also be reflected to the Joroff-model (figure 3.10). The CREM stage determines in what extend value is added towards the core business. Taskmaster and controller facilitate the core business / productivity to provide them in the day to day space demand. The productivity is as earlier mentioned according to Tangen (2005) a given thing
and must be seen as on, so no impact of efficiency or effectiveness. On this level the productivity of the core business is guaranteed. When on the controller level costs are reduced, the production process is optimised due efficiency and effectiveness, or even in the level of entrepreneur value is created by CRE, this increases the profitability of a company. The highest level is reached when CRE contributes to the competitive advantage of the core business. At this level the value adding is not solely by housing the productivity or maximising the profitability, at this level CRE contributes to the distinctiveness of the corporation also described by porter as the competitive advantage.

Corporations and business units provide accountability in three described dimensions. Both productivity and distinctiveness are subjective elements without a comparable quantification. This is why most performance measurements internal as external are related to financial profitability ratios. These financial ratios are conducted from annual reports and income statement that are subjected to strict guidelines by Dutch law. This creates a high level of comparability. Because of the consistence of these performance measurements many (financial) stakeholders use solely financial performance ratios (KPIs). However, the demand for social and quantitative ratios which reflect the distinctive performance grows, but the financial performance measurements are still dominant in the performance measurement landscape. Chapter 2 already described some important KPIs either chapter 5 provides extensive overview of most common used financial performance ratios and connects those ratios with the new IFRS lease accounting standard and CRE.

The different kinds of performance measurement can be linked to the main corporate and CRE strategies as the concept of added and exchange value of Appel-Meulenbroek (2012). This makes the alignment from strategy to measurement complete and gives an insight in how they correlate and interact with each other. As mentioned before the profitability performance measurements are all related to financial benchmarks and thereby suitable for cost orientated strategies. The distinctive performance measurements are related to differentiation strategies that increase the competitive advantage expressed in market share and have and indirect positive impact on financial results. (De Vries, 2007)

30 Civil code of the Netherlands 2 article 9. AEX listed companies are obligated to use the IFRS standards.

Figure 3.10: Adaption of the Joroff-model
A common belief is that performance measures should be a strict derived from the strategy. However Neely et al. (2001) argue the exact opposite and quote: “It is the want and needs of stakeholders that must be considered first, the only reason an organization has a strategy is to deliver value to stakeholders” (Neely et al., 2001, p. 6). According to Neely et al. (2001) first the needs of the different stakeholders need to be reassessed before a proper strategy can be formulated. The strength of this concept is that it creates a strong foundation for performance measures as it includes also stakeholders without financial incentives as employees and suppliers. (Tangen, 2005)

However, Neely et al. (2001) do not distinguish external and internal performance measurements. Another weakness is that Neely et al. (2001) have a limited scope and have no attention for the context (§3.1.1) where strategy is formulated.

As mentioned before organisations can be seen as open systems (§3.1.1) with an input and output which can be affected by the organisational and environmental context. Figure 3.10 reflects the evolution and interactions of performance measurements within this system. It distinguishes on the left side the stakeholder objectives, which are translated to specific performance goals. These stakeholder goals influence the organisational context as described in section (§3.1.1). Subsequently, the external and organisational context form together the obligations and context for strategy formulation. Specific goals for the overall and supportive strategies are indicators of an implemented strategy and are used for internal feedback in order to optimise the process of the value chain. After this sequence the performance is measured and reflected to the stakeholders. Stakeholders reassess their objectives and goals which complete the circle in a continuing process (figure 3.11).
3.5 Conclusion

“Which CRE strategies can be distinguished and what are their added values in a corporate perspective?” is the sub-question that has to be answered in this chapter. To understand CRE strategies, first, the essence of ‘strategy’ is discussed. Through the numerous amounts of studies and schools of thought it is hard to answer the question “what is strategy?” Nevertheless, the three prescriptive schools give a mainstay in formalising corporate strategies and the strategy formulation process. Where the schools slightly differ from each other they have important terms of agreement towards; alignment, strategy context, strategy formulation, strategy process and their impact on corporations overall performance. Substantive of the Strategy school, the CRE strategy should be a derivative of the corporate strategy, also known as alignment, in order to create a competitive advantage and realise the full potential. As stated before, the numerous amounts of studies and different schools of thought make it hard to determine a strict tool for alignment between the corporate strategy and the CRE strategy. It should be noted that the research conducted concerning CRE strategies is, for the greater part, limited to strategies that are derived from the positioning school perspective. The seven CRE strategies that are used within in this thesis are, thus, a derivative of strategies based on perspective schools of thought and distilled from studies based on the driving force methodology of Tregoe and Zimmerman (1980). These seven alternative CRE strategies are thereupon reflected to the corporate strategies of Porter (1985) and divided in Exchange and Use values (table 3.3). Furthermore, it is good to understand that strategies are implemented in order to ensure the corporations’ continuity. This continuity can be measured with three different performance measurements;

- Profitability,
- Distinctiveness, and
- Productivity.

Increasing shareholders value in terms of financial performance forms the main driver for AEX listed companies. Financial performance directly increases due to the implementation of Exchange value strategies which are in full control of the CREM division and are all financial related. The financial performance can also be influenced by the implementation of Added use value strategies but these are not in full control of the CREM, since it depends on the relation and interaction with other corporate resources. The Added use values increase the distinctiveness in terms of quality, image, innovative products et cetera, which improves the market share and thereby indirectly increases the financial performance.

Strategies are formed within an organisational context and an environmental context on the front-end. Changes within this context might impact strategy formulation or could be a reason to reassess the strategy policy. Therefore, CRE strategies could be indirectly affected. Regulatory issues, such as IFRS lease accounting, affect the general context by changes of the legal environment as section 3.1.1 showed and the organisational context by changing the performance needs of stakeholders as section 3.4 showed.
At the back-end, strategies are evaluated and reassessed by ‘forces’ of internal performance measurements which indirectly affect the overall corporate performance. For the exchange value strategies these performance indicators are financially driven and exposed by the proposed IFRS lease accounting regulations. Figure 3.12 visualises the places where these IFRS regulations may influence the (CRE) strategy process. It is however questionable whether regulatory changes will sufficiently impact the different aspects to lead to a reassessment of the corporate (real estate) strategy. The impact should, however, not be underestimated because the process described in figure 3.11 is only applicable when CREM departments already participate on the ‘Strategy’ level within the Joroff evolution ladder. For those CREM divisions that are not participating on this particular CREM level, new regulatory issues could form a bottleneck since they lack strategic motives. For those divisions lease accounting could be a catalyst to revise their CRE strategy and may result in an evolution within the Joroff-model. The regulatory impact on the CRE strategy is, thus, dependent on the evolution stage of the CREM department. However, the impact on the real estate implementation decisions, in order to realise the CRE strategy, seems to be another question. In chapter 4 this impact will be analysed further.
Corporate real estate decision-making

Now that the impact of IFRS lease accounting on CRE strategies is discussed, this chapter will subsequently zoom in on the decision-making processes within these strategies. Real estate portfolio decision-making is, therefore, the key aspect in this chapter. The goal is to answer sub-question 3; “Which changes to CRE portfolio decision-making processes can be made to alter the possible impacts of IFRS lease accounting on the corporate financial statement presentations?” In order to do so, first, an introduction to the portfolio decision-making processes in current real estate literature is provided (§4.1). Second, the possible link between IFRS lease accounting and making CRE operating decisions is discussed within the trichotomy data management, portfolio management, and transaction management and a management tool is provided (§4.2). Third, the link between the three exchange use strategies and the previously mentioned operating decisions is discussed (§4.3). Section 4.4 concludes this chapter and is the final section of the literature study of this thesis.

4.1 Portfolio decision-making

“(…) lacking an explicit real estate strategy, real property operating decisions may be made that are unrelated to or even in conflict with the enterprise’s overall business strategy rather than being consistent with the real estate strategy (…).”

(Nourse & Roulac, 1993, p. 488)

In order to be able to determine if it is likely that CREM divisions will change their CRE decision-making processes due to the proposed lease accounting changes, it is important to examine the balancing between corporations’ perceived need to provide financial statements that meet shareholder forecasts and the need to make (CRE) decisions that maximise the economic benefit of the company. Graham, Campbell, and Shiva. (2005), Jensen (2005), Cohen, Dey and Lys (2007), Badertscher (2011), and Fiolleau (2013) all stress the significant number of situations in which earnings are actively managed to obtain the most favourable corporate financial presentations as possible. To achieve this favourable financial reporting, companies can use, as described by Roychowdhury (2006), two general options with which accountants can choose to adapt their financial statements. The first approach is to alter the recognition for specific events by making assumptions that result in more favourable financial statement presentations, e.g. increasing current income through restructuring a transaction and providing a discount to change the date of a sale from the beginning of the next period to the end of the current period. This approach solely changes the recognition of an event on the corporate financial statement; it does not affect their actual operating expenses. The other method indicates that managers can make use of operating decisions to provide cash-flows that are more favourably concerning reporting earnings. (Canon & Fenbert, 2011)

It can, thus, be argued that corporate executives make questionable decisions when using one of the two approaches of ‘tailoring’ earnings management. This, subsequently, implies that the potential gains from such decisions can be significant (Fiolleau, 2013). This is supported by Graham et al. (2005), who offer several key observations in their study. First, recognising earnings are more important than cash-flows for the purposes of financial reporting because meeting -or even outperforming- benchmarks is considered to be of the utmost importance to corporate managers, because transcending benchmarks can yield (Canon & Fenbert, 2011): 1) an increase in stock price, 2) the position of the corporation on the capital markets, 3) an improvement of the (external) reputation of the management division, and 4) raising expectations of future growth. Second, when keeping cash-flows the same, considerable emphasis can be placed on smoothing accounted earnings, because
volatile earnings imply higher risk or lower growth forecasts. Third, managers are open to substitute economic value for more favourable financial statement presentations. (Canon & Fenbert, 2011)

With the provided perspective in mind, the next sections will explain how the actual decision-making process of CRE managers takes place.

4.1.1 Operating decisions

“Given the diversity, breadth and complexity of these critical real property operating decisions, there is a plethora of different alternatives that might be considered.”

(Nourse & Roulac, 1993, p. 488)

Chapter 3 provided three exchange value driven CRE strategies that are the only strategies that are likely to endure the impact of the proposed IFRS lease accounting rules, namely; 1) Reducing costs, 2) Increasing the value of the asset, and 3) Increasing flexibility. Besides these strategies Nourse and Roulac (1993) introduced fourteen real estate operating values. While the strategies vary in degrees of applicability to the strategic driving forces, as discussed in section 3.2, all fourteen real estate operating values that Nourse and Roulac (1993) describe should be taken into account and prioritised when implementing the CRE strategy. These fourteen CRE operating decisions are summarised as follows;

1. Location: Location strategies including country, regional submarkets, neighbourhood and the specific building.
2. Quantity: Amount of space needed for immediate and near-term needs and future expansion. Some organisations consciously control additional space beyond their anticipated needs for the purpose of speculating on future rental market conditions and/or controlling adjacent tenancies and uses.
3. Tenancy Duration: Time horizons of assured access to space; controlled by leases, options and direct ownership.
4. Identity / Signage: The perception of space and therefore advertising message sent to corporation’s audience.
5. Building Size / Character: Being a dominant or one of the tenants in a multi-tenant building influences the ambiance of the work environment and also has important real estate strategy consequences.
6. Building Amenities: Amenities available (food outlets, drug store etc.) in and proximate to a facility have a substantial influence on the perceptions and experiences of those working in the space.
7. Exterior Quality: Quality of landscape, building design and materials, public spaces, and building systems determine the visual appeal and influence the functionality of the space.
8. Company Space: Interior space, layout, design, finishes, furnishings, and art define the ambiance and functionality of the work environment.
9. Mechanical Systems: Heating, ventilation, air conditioning and elevators etc. influence the comfort of the work setting.
10. Information / Communication Systems: The support the building facility provides for communicating and processing information largely impacts the functionality of the space and the organisation’s productivity.
11. Ownership Rights: Short-term rental, long-term leases, plus options to extend and/or convert these positions to full ownership have critical operating and financial implications.
12. Financing: Payment arrangements for financial obligations; e.g. periodic monthly lease payments, inflation-indexed payments, portions of debt and how it is financed for acquired property has important financial consequences.
13. Control: Degree of control over other types of uses e.g. specific tenants in adjacent space.
14. Risk Management: Liability to third parties for acts and accidents at the property, responsibility for employees working in the space, and financial exposure to disaster (fire, storm, earthquake, etc.)

The studies of Nourse and Roulac (1993), Lindholm, Gibler and Leväinen (2006) and Gibler and Lindholm (2012) all stress real estate decisions involving concerns such as location, company space, and signage, which should be consistent with the overall CRE strategies and be supportive of other functional strategies (e.g. human resources, operations, finance, marketing) within the corporation. However, when interpreting these fourteen operating decisions should one consider the fact that organisational structures of companies are not everywhere the same (Acoba & Foster, 2003) and the decision-making process is subject to
changes with the implementation of these operating decisions in a way that gives the greatest benefit to the corporation and is acceptable for all stakeholders (Nourse & Roulac, 1993). The decision-making process varies, thus, in each company and depends on; the type of corporation, its size, corporate structure, and culture and the behaviour, personal preferences, priorities, and even the views of the managers that execute the decisions may significantly influence the outcome (Greenhalgh, 2008). With this in mind, one can imagine that there are numerous different alternatives to the described operating decisions that might be considered and numerous of CRE aspects that have an effect on organisational performance, as supported by Nourse and Roulac (1993). Another selection is, for example, made by Feijts (2006) and discussed, by Appel-Meulenbroek (n.d.). Feijts (2006) composed a list of 52 CRE aspects with respect to installation aspects, location aspects and structural aspects. It should, thus, be noted that the discussed operating decisions by Nourse and Roulac (1993), and the CRE aspects compiled by Feijts (2006) address a large part but not all of the focus areas of CRE.

As chapter 3 discussed, CRE decisions made in the framework of the CRE strategies improve the competitive advantage and core competencies of the company through; “creating and retaining customers, attracting and retaining outstanding people, contributing to effective business processes to optimize productivity, promoting enterprise values and culture, stimulating innovation and learning, enabling core competency and increasing shareholder wealth.” (Roulac, 2001, p. 130). The most important strategic deliberation for CREM divisions with executing these operating decisions is how to link the CRE strategy and the corporate business strategy, with the objective, as again stated in chapter 3, to increase shareholders value. Lindholm et al. (2006) summarise this view in figure 4.1.

4.1.2 Capture operating decisions in a model

Lindholm et al. (2006) provided a model (figure 4.2), in which they classified the CRE strategies and the corresponding operating decisions that add value to the core business. However, as Würdemann (2012) rightly points out, the analysis is limited to the investment and business focus, while Nourse and Roulac (1993) already mentioned financing as one of the fourteen operating decisions too. Würdemann (2012) argues that three perspectives should be taken into account in order to provide a complete overview of the key drivers of shareholder value that the CRE decision-making processes can influence, namely:

- Business perspective: the impact that CRE has on the core business process,
- Asset management perspective: the impact that CRE has on the investment strategy,
- Financial perspective: the impact that CRE has on the financing strategy.
Figure 4.2 shows that ‘Increasing the value of assets’ is an investment perspective, ‘Reducing cost’ is, partially, an investment perspective and partially a business perspective. The other strategies are regarded as a business perspective. It is remarkable that the effects of CRE on the corporate financial perspectives are not taken into account and this implies that the effects of CREM on financing are not taken into account. Würdemann (2012) argues that this can be explained by the dominant aspect of the business focus as illustrated in figure 4.1. The importance of the financial decision-making aspects are, however, not questioned as Roulac (2001) argues that CRE decision-making can, due to its scale, have significant financial implications (Roulac, 1986; Nourse & Roulac, 1993). Several studies support this view and have examined the impacts of CRE operating decisions on shareholders’ value (Chan, Gau & Wang, 1995; Ghosh, Rodriguez, & Sirmans, 1995; Rodriguez, & Sirmans, 1996; Manning, Rodriguez & Ghosh, 1999). However, Manning, Rodriguez and Ghosh (1999) argue that CRE decisions can a have significant impact on shareholders’ value, in contrast to the financial significance of CRE operating decisions that is hardly an issue for the corporate boards (Varcoe & O’Mara, 2011).

The large amount of management literature provides a wide supply of studies that discuss how CRE can increase productivity, can strengthen corporate marketing, trigger innovations, and to manage flexibility (e.g., Nourse & Roulac, 1993; Roulac, 1995; Roulac, 1996; Krumm, 1999; Roulac, 2001; Acoba & Foster, 2003; Allard & Barber, 2003; Krumm & Vries, 2003; Lindholm et al., 2006; Ali et al., 2008; Heywood & Kenley, 2008; McDonagh & Nichols, 2009). Also, literature concerning asset management that discusses how CREM can help reducing costs, and increase the value of the asset is also widely available (e.g., Hermon,
2005; Bosma, 2008), but Würdemann (2012) observed that remarkably few studies are concerned with the financing perspective. One would expect that a clear analysis on the impact of effective corporate tax rates, capital structure, cost of debt, and dividend policy is available, considering the enormous amount of corporate capital that is involved with CRE. This is, however, not the case. Furthermore, when the working capital and capital expenditures of companies are scrutinised, little evidence can be found considering decisions on whether to lease or to buy CRE have any significant effects on these two aspects. Based on this analysis, Würdemann (2012) developed the model as illustrated in figure 4.3.

Figure 4.3: The shareholder value driver perspective
Source: Adaptation of Würdemann (2012)

Figure 4.3 illustrates, thus, the macro value drivers of shareholders’ value and their corresponding management focus on micro value drivers that can be influenced by the CRE decisions that need to be made, whereby the position of the operating decisions and the influence of IFRS lease accounting are added. In essence, shareholders’ value is the result of cash-flows and the cost of capital\(^{32}\) (valuation component; hence the performance circle illustrated in figure 3.9). If figure 4.3 is compared with figure 4.1, two important aspects are added; 1) the macro value driver level, and 2) the financing aspects at the operating decision level\(^{33,35}\). One can use the macro value driver level to determine what aspects CREM divisions have to focus on in order to maximise value for the shareholders (Würdemann, 2012). However, the macro value drivers are too broad to be useful as operating decisions. Therefore, CREM divisions have to determine a set of micro value drivers to be able to act as operating decisions. Würdemann (2012) argues that, by using this model, it becomes clear how CRE contributes to the organisation and which choices should be made by CREM divisions. Würdemann (2012) states that these drivers will not have to be treated in the same

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32 Cost of capital is the required return necessary to make a capital budgeting project, such as building a new factory, worthwhile. Cost of capital includes the cost of debt and the cost of equity.

33 Leverage is defined as: total assets divided by the total assets minus total liabilities.

34 The cost of equity is the risk free rate plus the equity risk premium. Beta is the individual security’s systematic risk, as measured by its beta coefficient.

35 The effective rate that a company pays on its current debt.
way; in different business sectors, different drivers will be more important. For example, in a hotel, with a high fixed cost base, the most important driver is ‘sales’, as measured by the occupancy rate. This is a different situation compared with, for example, a bank making profits from a small margin between the rates at which the bank borrows and that at which it lends. More value will be created by improving interest margins and by reducing operating costs than can be derived from increasing the volume of business. The cost/income ratio is, thus, an important measure of performance (Würdemann, 2012). Based on this analysis CREM divisions have to focus on the micro value drivers and the according activities which add most value to the core business of the company. It should, however, be noted that Würdemann (2012) does not provide an insight, contrary to Lindholm et al. (2006), in what those ‘activities’ (i.e. operating decisions) might be (hence the upward arrows in figure 4.3). Furthermore, as chapter 2 showed, the proposed changes to IFRS lease accounting will draw attention to the influence of corporate financial aspects on CRE decision-making (figure 4.3). Chapter 3 added that CREM divisions that use the exchange value strategies are the only ones that can –theoretically- be faced with impacts by the new IFRS lease accounting regulations on their performance indicators since they are financially driven. This reduces the management focus to six (micro) exchange values; 1) Flexibility, 2) Costs, 3) Value of assets, 4) Leverage, 5) Cost of equity, and 6) Cost of debt (see figure 4.3).

4.1.3 Narrowing the current decision-making scope

With the model of Würdemann (2012) in mind and the fact that chapter 3 showed that the three exchange value strategies are key in this research, the numerous amounts of operating decisions are narrowed down to the ones that are in direct full control of CREM divisions within these strategies. Research conducted by Nourse and Roulac (1993), Lindholm et al. (2006), and Scheffer et al. (2006) found, as table 4.1 shows in line with table 3.1, the following operating decisions associated with the exchange value strategies.

<table>
<thead>
<tr>
<th>School</th>
<th>Study</th>
<th>Cost minimisation</th>
<th>Increasing flexibility</th>
<th>Increase value</th>
</tr>
</thead>
</table>
| Planning school | Lindholm et al. (2006) | Minimise acquisition and financing costs  
                     | Minimise operating expenses  
                     | Create economies of scale in acquisitions  
                     | Use workplaces more efficiently  
                     | Conduct routine maintenance  
                     | Balance between outsourced and In-house services  
                     | Act as a control mechanism  
                     | Utilise government incentives  
                     | Establish workplace standards | Choose leasing instead of owning  
                     | Negotiate short-term leases  
                     | Create flexible workplace solutions  
                     | Favour multiple use facilities  
                     | Select serviced offices | Obtain current valuations of facilities  
                     | Select suitable locations  
                     | Manage risk associated with properties  
                     | Make lease/buy decision on a facility by facility basis  
                     | Redevelop obsolete properties  
                     | Create and maintain IT-system for property management |
| Positioning school | Nourse and Roulac (1993) | Remote, less popular regions and sites (Location)  
                     | Minimum space per worker (Quantity)  
                     | General purpose building (Building size/character)  
                     | Minimise financial responsibility (Ownership rights)  
                     | Cost of capital trade-offs drive decision (Financing)  
                     | Minimise financial exposure (Risk management) | Less prime location (Location)  
                     | Short-term lease options (Tenancy duration)  
                     | Construction to favour easy modification  
                     | (Company space)  
                     | Control (control) | Consider impacts on demand of location decision (Location)  
                     | Secure more space/land than needed for own use (Quantity)  
                     | Longer terms (Tenancy duration)  
                     | Dominant tenant (Building size/character)  
                     | Critical to have ownership rights (Ownership rights)  
                     | Financing is a critical strategic priority (Financing)  
                     | Control is critical (Control)  
                     | Aggressive value creation involves more risk (Risk management) |
| Scheffer et al. (2006) | Workplace costs  
                     | Accommodation costs  
                     | Facility costs  
                     | Benchmarking  
                     | Corporate finance | Organisational flexibility  
                     | Financial flexibility  
                     | Technical flexibility | Acquisition and disposal of real estate  
                     | Redevelopment of real estate  
                     | Market analysis |

Note that the study of Singer, Bossink and van de Putten (2007) is not taken into account in table 4.1, in contrast to table 3.1, because they do not provide an overview of operating decisions per strategy.
Table 4.1 combined the ‘priority’ operating decisions as provided by Lindholm et al. (2006) of the three exchange value strategies and shows the operating decisions that can be allocated to the (micro) exchange values (black), as illustrated in figure 4.3. Of course, the values of table 4.1 are modified over time to adjust to changes in the corporation’s core strategies and this results in modifications to real estate decision-making (e.g., the operating decision “secure more space/land than needed for own use” provided by Nourse and Roulac (1993) is rather subject to fluctuations due to, for example, the implementation of Alternative Workplace Strategies; ‘Het Nieuwe Werken’ in Dutch). Table 4.2, subsequently, illustrates the allocation of all the priority operating decisions of table 4.1 that are most prevalent in (CREM) literature and, therefore, regarded key in decision-making under the micro value drivers, according to the model provided by Würdemann (2012).
4.2 Lease accounting and CRE operating decisions

“CRE potentially can make a difference to an organisation’s success, and can now begin to prove it.”

(Varcoe & O’Mara, 2011, p. 30)

Section 4.1 showed which operating decisions, that have been described in CREM literature, are in full control of CREM divisions. To answer sub-question 3: “Which changes to corporate real estate portfolio decision-making processes can be made to alter the possible impacts of IFRS lease accounting on the corporate financial statement presentations?”, it is, as stated before, necessary to know which operating decisions CREM divisions can manage in order to reduce the possible impacts of the proposed guidance on the corporate cost of capital (figure 4.3). Table 4.4 repeats table 2.4 which summarises the components that, as discussed in section 2.3, are required to manage, in order to be able to recognise (operating) leases on the balance sheet. When the lease accounting operating decisions, as discussed in table 4.4, are taken into account one can argue that table 4.3 is improperly organised and, far more important, incomplete. If subsequently the operating decisions of the tables 4.3 and 4.4...
are combined, this results in ten management buttons. Table 4.5 shows, in a random order, these management buttons (numbered) linked to the priority operating decisions that CREM literature provided (grey, blue and green) and linked to operating decisions provided by the 2010 ED and the tentative decisions by the IASB and FASB (white). The classification of these operating decisions is predominantly based on the description of the variables in section 2.3 and the classification provided by Nourse and Roulac (1993) and Lindholm et al. (2006).

<p>| | | | |</p>
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<tbody>
<tr>
<td>1</td>
<td>Rent</td>
<td>Base rent</td>
<td>Contingent rent</td>
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<td></td>
<td></td>
<td>Annual rent</td>
<td>square metres</td>
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<td>2</td>
<td>Location</td>
<td>Tax rate</td>
<td>Select suitable locations</td>
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<td></td>
<td></td>
<td></td>
<td>Impact on demand of location decision</td>
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<td></td>
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<td>Less prime locations</td>
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<tr>
<td>3</td>
<td>Number of assets</td>
<td>General purpose building</td>
<td>Create economies of scale in acquisitions</td>
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<td>Acquisition and disposal</td>
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<td>4</td>
<td>Lease term</td>
<td>Shorter-term lease options</td>
<td>Lease instead of owning</td>
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<td>Minimise financial exposure</td>
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<td>Minimise acquisition and financing costs</td>
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<td>Minimise financial responsibility</td>
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<td></td>
<td></td>
<td>Manage risk associated with properties</td>
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<td></td>
<td>Utilise government incentives</td>
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<td>5</td>
<td>Financing arrangement</td>
<td>Lease vs. buy decision</td>
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<td></td>
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<td></td>
<td>Minimise financial responsibility</td>
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<td>6</td>
<td>Purchase option</td>
<td>Lease incentives</td>
<td>Redevelopment</td>
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<td>Ownership rights</td>
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<td>7</td>
<td>Renewal options</td>
<td>Amount of renewal options</td>
<td>Length of renewal options</td>
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<td>Corporate finance</td>
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<td>Cost of capital</td>
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<td>Portion financed</td>
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<td>Amount financed</td>
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<tr>
<td>8</td>
<td>Discount rate</td>
<td>Service contracts</td>
<td>Balance between in-house and outsourced services</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Conduct routine maintenance</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Minimise operating expenses</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Facility costs</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Lease incentives</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Contingent rent</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Annual rent</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>square metres</td>
</tr>
<tr>
<td>9</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Subleases</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 4.5: Operating decisions lease accounting and literature combined

These management buttons, thus, act theoretically as a control tool for CRE managers to reduce and/or structure the possible impact(s) of changes to the lease accounting guidance on companies’ financial statements. To obtain a complete picture of decision-making processes, the operating decisions that were ‘missing’ in the model of Würdemann (2012) (figure 4.3) are arranged in figure 4.6. This enumeration supports the findings in the studies of Varcoe and O’Mara (2011) and Würdemann (2012) who both argue that some operating aspects of how the CREM division undertakes its management scope have a clear relationship with an organisation’s financial performance. To what extent these ten buttons should be altered is a question that should be answered for every real estate transaction a CREM division is intending to make and of course in the context of the real estate strategy. Section 4.3 will elaborate on these important additional thoughts.

The ‘daily practices’ of a CREM division can be classified into the trichotomy; data management, transaction management, and portfolio management (CBRE, 2010). This trichotomy is scrutinised to ascertain what impact the proposed IFRS lease accounting guidance and, by extension, managing -one of- the ten buttons can have on the ‘daily practices’ of a publicly traded CREM division.
Figure 4.6: The shareholder value driver perspective completed with operating decisions
Source: Adaptation of Würdemann (2012)
4.2.1 Data management

The lease accounting proposal stipulates that all operating leases should be capitalised using the present value of expected lease payments. Therefore, CRE managers will first need to catalogue existing leases and gather –the correct- data about all ten management buttons; the number of assets, the locations, the financing arrangements, the lease terms, renewal options, purchase options, base rents, subleases, service contracts and discount rates to measure the amounts to be included on balance sheet. Gathering and analysing the information could take considerable time and effort, considering the number of leases that have been taken up years ago at numerous decentralised locations, the commencement dates and the records available (PwC, 2010; Ernst & Young, 2011; Deloitte, 2012; KPMG, 2012; CBRE, 2010).

Leonard and O’Brien (2012) argue, furthermore, that the impact of the change will not be restricted to external reporting; internal reporting information, including financial budgets and forecasts, will also be affected. This could imply that the relationship between the corporate Chief Financial Officer (CFO) and CRE managers will have to change, because every time a lease occurs the balance sheet will be impacted. Thereby, the proposed lease accounting guidance requires recognising the use of real estate –both leased and owned– explicitly in the financial statements of corporations. This shift will greatly enhance the visibility of CRE stakes and costs. Certainly, in the first few years this will have an impact on balance sheet ratios and thereby raise questions among shareholders. Questions that have not been asked for a long while and that require a board to be more fully aware of their CRE position. This change in accounting standards will automatically shift the way in which corporations communicate about their CREM. While in the past information on CREM was often opaque and incidental, now an era is entered in which the financial reporting will ensure that the numbers appear more often and more prominently. (Brounen et al., 2012) Figure 4.7 illustrates this CREM communication in a matrix.

![Figure 4.7: CREM communication](source: Adaption of Brounen et al. (2012))

The information is considered opaque when the numbers are scarce and appear only in technical notes, while information is transparent when numbers are presented notably in combination with a clear discussion of CRE strategy and vision. Corporations that are in the denial phase I tend to communicate only the bare necessities, as it is hard to talk about matters that one ignores. In case corporations undertake SLBs or dispose of headquarters to free up capital, the numbers become more transparent as market values are typically involved here. But, these transactions are more incidental than structural. One could even argue that IFRS lease accounting could transfer corporations automatically into the acceptance phase V, especially when CREM communication is concerned. The information regarding a company’s real estate use and costs will become much more transparent and appear continuously in all reporting.

4.2.2 Transaction management

The proposed lease accounting changes can cause transaction processes to be more time consuming because the reassessment of changes in lease contracts can be a tug of war between lessees and lessors. Most evident is the fact that the lessee would have to use a
discount rate to calculate the PV of the leased asset. As chapter 2 discussed the lessee would use the rate the lessor charges the lessee when that rate is available; otherwise, the lessee would use its incremental borrowing rate (i.e. the specified WACC). The rate the lessor charges the lessee could be; the lessee’s incremental borrowing rate, the rate implicit in the lease or, for property leases, the yield on the real estate asset. When more than one indicator of the rate that the lessor charges the lessee is available, the rate implicit in the lease should be used. This, thus, means that one can ‘negotiate’ to a certain extent the discount rate the lessee will have to use because lessors will not release their yields without a struggle. Furthermore, it will first be necessary to determine whether specific elements of a lease can be viewed as separate components with future negotiations, since service components do not have to be capitalised. Thereby, accurate estimations have to be made by CRE managers of changed negotiation conditions, such as rent changes, by lessors. In addition to the initial implementation process there will be an on-going workload to review the lease accounting for all the leases at all accounting dates. At every accounting date the core assumptions adopted in terms of rent and options will need to be reviewed to ensure that they do not differ significantly from those previously adopted. For example, it may be necessary to reassess the probabilities of break options being exercised based on updated business planning. (CBRE, 2010)

Linking real estate and corporate finance on an on-going basis is, as supported by Krumm and Linneman (2001), thus essential in determining the overall performance and success of managing CRE. DTZ (2010, p. 9) thereby states that “the lease accounting rules are too complex and the audit risk too great for these tasks to be performed individually in the field and reported back to headquarters”. This, again, implies that the relationship between, inter alia, the corporate CFO and CRE managers will have to change.

4.2.3 Portfolio management

As stated in chapter 2, the advantage of improving performance measures by clearing the corporate balance sheets with off-balance sheet accounting disappears. This fact results in reconsidering the financing arrangement (‘lease versus buy decision’), long-term versus short-term lease decisions and floating versus fixed rate contracts. For example, an increased attractiveness of ownership compared with long-term leasing may be expected because ownership will become relatively more attractive and lease terms would be shortened because the ratios used by the investor and lender can be considerably affected by the grossed-up balance sheet. To minimise consequences, CRE may be directed to entering into shorter lease-terms. Furthermore, transactions such as SLBs it is the case that the desire to achieve operating lease treatment has influenced transaction structuring and thus has impacted decision making but probably not the actual decision to undertake the transaction (CBRE, 2010). This in turn will have great impact on portfolio management. Thereby, many corporations have not needed robust processes and controls for leases in the past because existing accounting models did not require leases to be periodically revisited. The proposal that leases should be re-measured will require CRE managers to redesign processes and controls to ensure proper management of all lease agreements. Initial recording on balance sheet and annual reassessment -think of contingent rent- of lease terms and payment estimates may require significant and complex changes of CRE managers to existing processes and internal controls, including support for significant management assumptions. Decision-making processes concerning portfolio strategy and portfolio management will, thus, be far more complex, especially when the corporate CREM division does not operate on the ‘Strategist’ stage of the Joroff-model. (PwC, 2010; Ernst & Young, 2011; Deloitte, 2012; KPMG, 2012; CBRE, 2010)

These possible changers largely relate to the fact whether the assets are core (essential to the business), key (important but not critical), captive (low strategic value) or fluid (former high strategic value - now low), see figure 4.8. A general statement could be made that decisions about the lease term of financing arrangement of strategic real estate assets (e.g., highly specialised factories or retail locations) will possibly not be altered and ‘fluid’ real estate assets (e.g., (back) offices) are the assets in the decision-making processes that could bear the
most significant impact of the proposed changes to IFRS lease accounting because they can be easily replaced.

4.3 Linking CRE operating decisions to CRE strategies

"In practice, since few companies are explicit in articulating their real estate strategies, real estate operating decisions tend to get made in a vacuum. That such decisions are often inappropriate, leading to frustration for those working in the space and financial disappointment is not surprising."

(Nourse & Roulac, 1993, p. 488)

For the CRE operating decisions outlined before to add value to the company, the implementation of real estate operating decisions in the context of the CRE strategy is crucial. It is crucial because one has to confirm that the real estate decision is consistent with the company’s real estate strategy and therefore its overall business strategy, but also that the CRE operating decision are consistent with the company’s other critical component strategies for such factors as human resources, operations, marketing, finance and information. Although a real estate operating decision may logically follow the real estate strategy and thereby be consistent with the overall business strategy, if that real estate decision is not linked to, consistent with, and supportive of the other sub-strategies for the company, it will necessarily be less effective than it might otherwise be. (Nourse & Roulac, 1993)

As discussed in chapter 3, all real estate operating decisions must be addressed in each CRE strategy. These operating decisions are made explicitly or implicitly every time a real estate decision is made, either through the explicit implementation of the transaction or as an implicit decision in the form of not implementing a transaction. This also applies to managing the ten buttons. One approach to identifying certain dominant considerations is linking the ten buttons to the three CRE strategies. In table 4.6 a first attempt is made to rank the ten management buttons for each of the Exchange use strategies. The ranking is based on the operating decisions per management button that Lindholm et al. (2006) and Nourse and Roulac (1993) prioritised in their studies per strategy.
Grabowski (2012) adds that despite the benefits received from following bounded rational process and logical criteria, it appears CRE decisions do not always align with overall strategies nor are they always based upon logical criteria. This finding supports the quotation of Nourse and Roulac (1993, p. 488) at the start of this section that not all companies are located at the ‘Strategist’ stage in the Joroff-model. This means that the proposed changes to lease accounting could even be of greater impact. Grabowski (2012) continues that organisational buying suggests individual decision makers’ preferences, lifestyles, attitudes, and emotions play an important role in CRE investment decisions. Moreover, the operating decisions in these organisations like most decision-making processes appear to be made through messy political processes with individuals engaging in political tactics such as co-optation, coalition formation, and use of information to enhance their power (Eisenhardt & Zbaracki, 1992). To understand these processes may require examining the role of exceptional people and extreme circumstances, the enabling and constraining forces of the environment, and exploring some of the conditions in which mixtures of these occur (Pettigrew, 1987). The negotiating tactics and methods to assist these managers in the middle are described by Lax and Scbenius (1986). The important point in such negotiations, however, is that the managers in the middle, as well as all the other actors, must identify their real interests. Strategy ultimately is a consistent network of linked agreements (Lax, 1986). To guide the corporation in making consistent networks of linked agreements, it is necessary to consider explicitly CRE strategy. Corporations often pursue multiple CRE strategies, with selection of the appropriate collection of real estate strategies being a function of the driving force of the overall company (Nourse & Roulac, 1993). It should be noted that for some corporations these expected consequences -based on the amount of off-balance assets- will present just another compliance issue entailing costs that will need to be managed. In contrast, however, PwC (2010), Ernst & Young (2011), Deloitte (2012), KPMG (2012) and CBRE (2010) stress that the lease accounting changes can be significant for corporations with large operating lease commitments, especially for the industry retail and trade as table 2.6 showed. With this additional view on decision-making processes in mind, figure 4.6 proves once again to be of great importance in making statements about CRE decision-making and makes it
necessary to test the practical relevance of the ten provided operating decisions. This test is conducted in chapter 6.

4.4 Conclusion

Sub-question 3 had to be answered in this chapter: “Which changes to CRE portfolio decision-making processes can be made to alter the possible impacts of IFRS lease accounting on the corporate financial statement presentations?”. To be able to answer this question an enumeration in table 4.5 is given of the most important operating decisions discussed in CREM literature and the priority operating decisions discussed by the IASB and FASB. It was shown that managing operating decisions is more complex than the 'lease versus buy' decision, or than just reducing space use and lowering occupancy costs. Managing a CRE portfolio is about finding the right balance between optimising the performance of the real estate portfolio, for example; minimising costs and increasing returns on investment and the value of real estate to core business processes. Each balance is tailor-made for the organisational setting; each has its pros and cons. The proposed lease accounting guidance will most likely alter this balance. Table 4.5 summarises the most important operating decisions that may be of interest to adapt and find, once again, the right balance. IFRS lease accounting requires recognition of the use of CRE –both rented and owned– in the financial statements of corporations. This shift will greatly enhance the visibility of CRE stakes and costs. Certainly, in the first few years this will have an impact on balance sheet ratios and thereby raise questions among shareholders. Questions that have not been asked for a long time and that require a board to be more fully aware of their CRE position. This change in accounting standards will change the way in which corporations communicate about their CRE. The proposed changes to IFRS lease accounting will draw the attention to the influence of corporate financial aspects on CRE decision-making. And vice versa: the influence of CRE on (the financial aspects of) the corporate strategy. Furthermore, it is argued that IFRS lease accounting will catapult corporations automatically into the acceptance phase V, especially when CREM communication is concerned. The information regarding a company’s real estate use and costs will become much more transparent and appear continuously in all reporting. This will make the corporate boards more aware of the impact of CRE on the corporate strategy. A good understanding of its resources is a critical ingredient for a successful strategy. Such knowledge creates confidence among business units who are then more willing to cooperate and depend upon the CREM division to make value-adding decisions. It also ensures that CREM can communicate its contribution to the company in a language that the top decision makers understand. This ‘language’ will get far more important when, as argued, the relationship between the CRE executive and the CFO will change due to the proposed IFRS lease accounting rules. As a result, CRE will attract more attention and new questions about CRE and its strategy will be asked. CRE managers will, thus, have the potential to shape future successes for organisations. Furthermore, the transparency and structure the proposed IFRS lease accounting rules create, provides the opportunity for CREM divisions to revise their CRE strategy and operating decisions to be able to reach the ‘Strategist’ stage on the Joroff-model. But again, lacking an explicit CRE strategy, operating decisions may be made that are unrelated to or even in conflict with the corporate business strategy rather than being consistent with the real estate strategy and thereby reinforcing the overall business strategy. Thereby, revisions are most likely to arise with ‘fluid’ assets since their lack of strategic importance. Furthermore this chapter provided the ten management buttons to alter the possible impact of IFRS lease accounting. Figure 4.9, on the next page, summarises the literature study and chapter 6 will test these assumptions in practice.
Figure 4.9: Management support tool
IFRS lease accounting impact on Corporate Real Estate Management
Macro analysis

To understand the magnitude of impact of the proposed lease accounting regulations, this chapter examines the theoretical impact of the proposed IFRS lease accounting guidance on the corporate balance sheets, consistent with the ED of August 2010 and the additional board discussions and papers. For the theoretical impact measurement an Excel model is developed to determine the significant changes concerning the balance sheet, income statement and performance ratios. However, accounting is not a theoretical framework appropriate for one’s own interpretation. Therefore, §5.1 examines the capitalisation approaches used in previous studies and discusses the model that is used for the macro analysis. Furthermore, the necessary information is not always available in financial statements, thus paragraph §5.2 sets out assumptions that are used within this model. Section §5.3 contains the essence of this chapter; the theoretical impact of IFRS lease accounting for each individual company. Finally, in the conclusion (§5.4) the relationship of the assumptions, lease accounting regulations and their impact will be discussed.

5.1 The use of financial statements

“The off-balance characteristic of operating leases is a unique selling point of these transactions and is promoted as such.”

(Lückerath-Rovers, 2007, p. 83)

Financial statement users highly rely on the transparency and completeness of these statements. Notwithstanding that financial statement users assumed to have a certain level of knowledge when it comes to business, economics and accounting Lückerath-Rovers (2007) argues that operational lease disclosures are not uniform and lack in understandability and transparancy. It is important to understand that besides these commitments recorded in the balance sheet a company has additional liabilites, such as operational leases, that affect KPIs such as leverage. Operating leases are additional ‘new’ non-cancable lease obligations and only incorporated within the disclosures notes. Contrary to other notes of long term liabilities these notes are additional information and not yet capatalised on the balance sheets. In additional statement users should be aware that these commitements are future nominal commitments and still include an interest part of repayment. Therefore these liabilities cannot directley be added to the balance sheet liabilities. Section 5.2 describes in further detail the current disclosure requirements and the differences in transparancy between corporations. To compare the off-balance operating-lease commitments with on-balance commitments, the user should eliminate the interest part of the lease commitments by means of a capitalisation approach. And, subsequently, add this amount to the total liabilities to get a more realistic insight in the financial position of a corporation. This stresses the importance of a solid capitalisation approach. (Lückerath-Rovers, 2007)

Credit rating agencies already capitalise these operating lease expenses in order to estimate future lease obligations and estimate the total debt. But these estimations are often nothing more than a well-educated guess, since only (CRE) lease users can provide an accurate insight in income statements and balance sheet effects (Lennard & Nailor, 2000).

Constructive capitalisation of the off-balance liabilities is not only common practice within the credit and rating agency industry- also academics comment on this issue. Nelson (1963) was one of the first who investigated the capitalisation item. He investigated eleven U.S. corporations who voluntarily disclosed additional off-balance lease commitments. Nelson (1963) increased the assets and liabilities with the PV of the additional commitments. Subsequently, Nelson (1963) concluded that the capitalisation of lease obligations makes the performance ratios more meaningful since leases are respected for what they really are; a source of financing. As a consequence he argues that “financial analysts could easily have
made faulty decisions” (Nelson, cited in Fülbier, Silva, and Pferdehirt, 2006, p. 5) based on figures not adjusted for lease obligations. (Fülbier et al., 2006; Lückerath-Rovers, 2007)

As chapter 2 stated, was SFAS 13 introduced in 1976. This regulation was introduced to reduce the off-balance finance structures and made the distinction between operating and finance leases. As a result, corporations collectively structured finance leases (on-balance) to operational leases (off-balance). These effects were not unnoticed by the academics whereupon a “golden age” relating to capitalisation research followed.

Imhoff, Lipe, and Wright (1991) followed Nelson (1963) and investigated fourteen pairs U.S. corporates that were exposed to leases. They concluded that constructive capitalisation had a significant impact on their financial ratios; ROA (-22%) and debt to equity ratio +119%37. These results strongly suggest that constructive capitalisation of operational lease commitments is necessary for an accurate evaluation and comparison of financial performance of different corporates. Studies of Beattie et al. (1998), Fülbier et al. (2006) and Angels, Soledad, and Neus, (2010) conducted a similar research for; 2,228 U.K., 80 German and 56 Spanish listed corporations, respectively. They all confirmed the finding of Nelson in 1963 that constructive capitalisation has significant impact on financial performance ratios.

5.1.1 Capitalisation approaches/methodology

Through the capitalisation of operating lease obligations a more accurate and transparent insight is given in the total financial liabilities. Thereby the comparability between high and low operational lease exposed corporations improves and places the potential impact in a context. “Constructive capitalisation requires the estimation of the amount of debt and assets that would be reported on the balance sheet if operating leases had been treated as financial leases from their inception”. (Imhoff et al., 1991)

However, there are numerous capitalisation theories that could be applied with each of their distinctive characteristics. Lückerath–Rovers (2007) investigated seven of these approaches and divided these in two general types (table 1.3.1), the multiple methods and the PV methods.

<table>
<thead>
<tr>
<th>Capitalisation approaches of operating leases</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Multiple methods</strong></td>
</tr>
<tr>
<td>8-times rent</td>
</tr>
<tr>
<td>UBS Warburg</td>
</tr>
<tr>
<td><strong>PV methods</strong></td>
</tr>
<tr>
<td>Imhoff et al., (1991)</td>
</tr>
<tr>
<td>Lückerath -Rovers, (2007)</td>
</tr>
<tr>
<td>Fülbier et al., (2006)</td>
</tr>
</tbody>
</table>

Table 5.1: Capitalisation approaches of operating leases

The multiple methods are primitive of nature and determine the capitalised value of the operating leases by multiplying the minimum operating lease commitments with a fixed factor. Despite the primitive nature they are still frequently used in practice by prominent stakeholders in financial markets as Moody’s and UBSWarburg. The most important reason why this method has a prominent place is its simplicity. The ‘rule of thumb’ used by multiple methods varies from six to eight times the rent which can be adjusted for the creditworthiness of a corporation. (Lückerath-Rovers, 2007)

The PV methods capitalise all future lease commitments and eliminate the interest part that is incorporated in the provided future lease obligations. Previous studies of e.g. Angels et al., (2010), Beattie et al. (1998) Fülbier, et al., (2006) and Lückerath-Rovers, (2007) all used the model of Imhoff et al., (1991) (hereafter ILW method) as fundament of their capitalisation approach. They each made slight changes in order to improve or adapt the model to a specific asset-class.

To estimate the effect of the new IFRS lease regulations, the ILW capitalisation approach is slightly adapted and also used for this study. In contrast to the multiple methods the capitalisation approach encompasses the effects on the lease liability as the ROU asset. Thereupon it gives a more realistic estimation since all future obligations are included, where

37 The debt to equity ratio is also used as the definition of leverage within this thesis.
with a multiplication method only the first year is in the consideration. The adaptations to the original ILW model consist of different assumptions (§5.3), and the method that is used for determining the ROU asset and the Present Value Lease Liability (PVLL).

5.1.2 Capitalised lease liability and right of use asset

The main purpose of the model is to determine the additional lease liability on the balance sheet also known as the present value of the lease liability (PVLL). The present value methods described in table 5.1 all calculate the PVLL by discounting the future operational lease obligations according the ‘constructive ILW capitalisation method’ (equation 5.1). This method captures the different timings of the lease liabilities and discounts the interest part which is essential to determine the consequences under the proposed IFRS lease regulations.

Present value lease liability (PVLL)

\[
PVLL = \sum_{t=1}^{n} \frac{CF_t}{(1 + i)^t}
\]

Equation 5.1: Effective interest method for PVLL

Source: Lückerkath-Rovers, (2007)

To realise the most realistic and reliable data we deviate from the original ILW model. Imhoff et al., (1991) apply the model to the total of future lease obligations and dealt with them as one single lease contract. This method ignores the fact that a portfolio is a composition of different lease contracts with divers lease lengths. Classifying the leases as one average-lease term will be to simplistic. Therefore this thesis deviates from the ILW model and adopted the method of Fülbier et al., (2006); who break up the lease obligations in five CFt tranches with different lease terms (one till five years and more than five years) and different annual lease payments. Subsequently, the ILW model is applied separately over the five different tranches. The tranches are identified by; CFt - CFt+1, where the last tranche is assumed to have equal annual payment to CF5 with a remaining lifetime of 5+(CF5/CF5). Summarising these tranches, results in the total amount of lease liability and ROU adjustments. This method reflects a more realistic view of a lease portfolio. Since it incorporates the fact that lease contracts ends on various moments. The studies of Lückerkath-Rovers (2007) and Beattie, Edwards, and Goodacre (1998) use a weighted lease life in order to solve this problem.
Table 5.2 visualises the tranche principle.

Table 5.2: Tranche method

<table>
<thead>
<tr>
<th>Year</th>
<th>Example operational leases input</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>€ 1,750</td>
<td>€ 300</td>
<td>€ 1,000</td>
<td>€ 500</td>
<td>€ 300</td>
<td>€ 279</td>
<td>€ 259</td>
<td>€ 240</td>
<td>€ 223</td>
<td>€ 223</td>
<td>€ 54</td>
</tr>
<tr>
<td></td>
<td>Lease expense real estate</td>
<td>€ 300</td>
<td>€ 279</td>
<td>€ 259</td>
<td>€ 240</td>
<td>€ 223</td>
<td>€ 223</td>
<td>€ 223</td>
<td>€ 223</td>
<td>€ 223</td>
<td>€ 223</td>
<td>€ 54</td>
</tr>
<tr>
<td></td>
<td>Lease expenses tranche I</td>
<td>€ 21</td>
<td>€ 20</td>
<td>€ 19</td>
<td>€ 17</td>
<td>€ 17</td>
<td>€ 17</td>
<td>€ 17</td>
<td>€ 17</td>
<td>€ 17</td>
<td>€ 17</td>
<td>€ 17</td>
</tr>
<tr>
<td></td>
<td>Lease expenses tranche II</td>
<td>€ 19</td>
<td>€ 19</td>
<td>€ 19</td>
<td>€ 19</td>
<td>€ 19</td>
<td>€ 19</td>
<td>€ 19</td>
<td>€ 19</td>
<td>€ 19</td>
<td>€ 19</td>
<td>€ 19</td>
</tr>
<tr>
<td></td>
<td>Lease expenses tranche III</td>
<td>€ 17</td>
<td>€ 17</td>
<td>€ 17</td>
<td>€ 17</td>
<td>€ 17</td>
<td>€ 17</td>
<td>€ 17</td>
<td>€ 17</td>
<td>€ 17</td>
<td>€ 17</td>
<td>€ 17</td>
</tr>
<tr>
<td></td>
<td>Lease expenses tranche IV</td>
<td>€ 223</td>
<td>€ 223</td>
<td>€ 223</td>
<td>€ 223</td>
<td>€ 223</td>
<td>€ 223</td>
<td>€ 223</td>
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<tr>
<td></td>
<td>Total</td>
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<td>€ 279</td>
<td>€ 259</td>
<td>€ 240</td>
<td>€ 223</td>
<td>€ 223</td>
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<td>€ 223</td>
<td>€ 223</td>
<td>€ 223</td>
<td>€ 223</td>
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</tbody>
</table>

In order to obtain a complete analysis of the balance sheet effects also the ROU asset has to be determined. The IASB introduced two methods for determining this ROU asset in the 2010 ED; the I&A approach and the SLE approach. For all previous studies mentioned in table (5.1) the method for determining the ROU is comparable to the I&A principle. This is not surprising since operating leases within this approach are fully treated as a financial lease (which was the first intention of the boards). Due the heavy lobby from corporates a second-mitigated form of the I&A approach was introduced; the SLE approach. According to the last ED all CRE operational leases today would be categorised under the SLE approach in the future. Since this thesis focuses on the impact of IFRS lease accounting in relation with CRE, previous ILW based models (I&A) are not applicable for determining the ROU under the SLE approach.

Under the SLE approach the amortisation of the ROU is a balancing figure to obtain the straight-line expense (ROU amortisation = cash flow straight line – interest expense). Since in our model the straight-line expense does not deviate from the actual cash flow (due to the tranche principle) the ROU asset remains equal to the PVLL. This is a conservative assumption, because when the actual expense deviates from the SLE, what in practice commonly occurs due to indexation, the difference will affect also the equity position. Notwithstanding an extensive methodology which incorporates equity adjustment would be more complete, previous studies concluded that these adjustments are that small they will result in similar conclusions. (Angels, Soledad, & Neus, 2010)

\[
ROU = PVLL_{t-1} - \sum_{t=1}^{n} (CFS_t - I_t)
\]

Equation 5.2: ROU for the SLE approach

38 According to the last ED considering figure 2.12 in chapter 2.

39 The bright line test described in paragraph 2.2 The future of accounting rules divides leases in to financial and operational leases. According the proposed ED this bright line test is used to determine if real estate leases are qualified under the SLE or I&A approach. Following these guideline all current operational leases would be qualified under the SLE approach in the future.
5.1.3 Non-CRE leases

In order to place the CRE effects in the context of the total impact and to compare corporations with a high and low exposure to CRE leases, this thesis is not limited solely to CRE related operational leases. The remaining operational leases are all considered to be I&A leases. The PVLL measurement will be the same as for the SLE method. However, where the ROU of the SLE approach is deviated from the ILW model, this model is adopted (with the tranche distinction) for the non-real estate leases. Imhoff et al. measure the ROU-asset by multiplying the lease liability with a fixed asset-liability ratio (equation 5.3). This ratio depends on the total life, remaining life, life, depreciation method and the discount rate. Imhoff developed a table (appendix I) where this ratio can be determined with a limited error margin. Imhoff et al. even argue that this ratio generally will be between the 60% and 80% implying that assuming a ratio of 70% is a reasonable rule of thumb, proviso that Imhoff developed the model in 1991 and the lease landscape changed significantly this thesis does not copy this rule of thumb of 70%, but applies a fixed ratio of 81%. This corresponds to total lease life of ten years, a discount rate of 10% and an expiration factor of 50%. The difference between the PVLL and the ROU asset is adjusted by the equity position. Since the lease liability always exceeds the ROU asset the equity is always adjusted downwards. However, due to the existence of taxes this equity adjustment is not merely the difference between PVLL and the ROU. Imhoff et al. (1993) use equation 5.4 to adjust the equity position and equation 5.5 deferred taxes on the balance sheet.

\[ \text{ROU} = \text{AP} \times \text{PVLL} \]

\[ \text{Equity adjustment} = (1 - t) \times (\text{PVLL} - \text{ROU}) \]

\[ \text{Deferred taxes} = T \times (\text{PVLL} - \text{ROU}) \]

The underlying assumptions for determining the PVLL and ROU are as follows:
- At the inception of the lease, the book value of the leased asset is equal to the value of the lease liability, (Fülbier et al., 2006)
- The capitalised asset and the capitalised liability both devaluate to zero at the end the lease, (Imhoff et al., 1991)
- The lease liability and the inputted interest are calculated using the effective interest method, (Deloitte Development LLC, 2012)
- Lease payments are constant over the lease tranche. (Fülbier et al., 2006)

**SLE specific:**
- All operational leases related to CRE are treaded under the SLE method (chapter 1.2.1.)
- The ROU asset depreciates equal to the PVLL

**I&A Specific:**
- The ROU asset depreciates using a fixed asset proportion factor (Imhoff et al., 1991)

These assumptions are comparable with 100% debt financed annuity financial leases. For the I&A approach the related assets depreciate on a straight line basis, which is simulated by the fixed asset proportion ratio. For the SLE approach the related asset is in practice a fraction lower than the lease liability- in this model the related asset is equal to the lease liability, which is a conservative assumption. The different approaches are visualised for a single lease in figure 5.3. (Lückerath-Rovers, 2007)
5.2 Input variables

Not all the input variables are publicly available. Therefore, the macro analysis is subjected to assumptions. Table 5.3 provides insight in the information that is needed for a proper capitalization and the information that is available. It makes clear that most information is not accessible for external financial statement users. For most of the data entries assumptions have to be made. Therefore the outcome is not more than a well educated guess exposed to a certain amount of sensitivity. This stresses that only corporations can provide accurate and reliable information about future operating lease commitments and their credibility.

![Diagram: Relation PVLL and ROU](source)

Table 5.3: Information for capitalisation

<table>
<thead>
<tr>
<th>Information need for capitalisation</th>
<th>In annual reports</th>
<th>Assumptions to be made</th>
</tr>
</thead>
<tbody>
<tr>
<td>I Implicit rental rates</td>
<td>Not disclosed</td>
<td>Estimation</td>
</tr>
<tr>
<td>TL Total lease life</td>
<td>Not disclosed</td>
<td>The future lease commitments are subdivided in five lease tranches of 1 year, 2 years, 3 years, 4 years and &gt;5 years</td>
</tr>
<tr>
<td>RL Remaining life</td>
<td>Not disclosed</td>
<td>The future lease payments are subdivided in five lease tranches of 1 year, 2 years, 3 years, 4 years and &gt;5 years</td>
</tr>
<tr>
<td>CF&lt;sub&gt;t&lt;/sub&gt; Lease payments for year t</td>
<td>Lease payments are disclosed in the following categories:</td>
<td>Constructive capitalisation approach is used to calculate the present value of the lease liability (PVLL)</td>
</tr>
<tr>
<td></td>
<td>Expiring within 1 year</td>
<td>Assumption that the initial value of the leased asset (PVA) is equal to the present value of the lease liability (PVLL)</td>
</tr>
<tr>
<td></td>
<td>Expiring within 1-5 years</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Expiring after &gt;5 years</td>
<td></td>
</tr>
<tr>
<td>PVLL&lt;sub&gt;0&lt;/sub&gt; Initial value of the lease</td>
<td>Not disclosed</td>
<td>Assumption that the initial value of the leased asset (PVA) is equal to the present value of the lease liability (PVLL)</td>
</tr>
<tr>
<td>I Initial value of the leased asset</td>
<td>Not disclosed</td>
<td></td>
</tr>
<tr>
<td>T Company’s marginal tax rate</td>
<td>Not disclosed</td>
<td>Estimation</td>
</tr>
<tr>
<td>Depr annual depreciation of asset</td>
<td>Not disclosed</td>
<td>The depreciation of the leased asset is determined by the lease payment minus the interest expenses. With as principle that all CRE operating lease are accounted under the straight line expense method. For the SLE approach an asset proportion is estimated.</td>
</tr>
</tbody>
</table>

Figure: 5.3 Relation PVLL and ROU
Source: adaptation of Imhoff et al. (1991)
5.2.1 Discount rate

As mentioned before the essence of the PV capitalisation approach is to extract the interest component from the operating lease liabilities. The added lease liability then represents a fair value and is comparable to if the lease liability would be treated as a financial lease from the beginning. According to the ED each lease should be capitalised by the unique discount rate used by the lessor. Since lessors are not transparent in lease-payment calculations these discount rates are mostly not available for corporates- not to mention for financial statement users. The alternative discount rate is the corporations’ implicit borrowing rate at the moment of lease inception. Also this data is hardly disclosed in annual reports or publicly available. Therefore many previous studies used a fixed discount rate of 10% e.g. Beattie, et al. (1998), and Imhoff et al., (1991). A fixed discount rate for all companies and leases may be too general. Therefore, this model uses the interest rate for long-term debt and verifies this discount rate with data compiled from a previous survey (appendix II) send to all participants. If the discount rate for long-term debt is not available and there is no feedback from the survey, a conservative percentage of 10% is used.

5.2.2 CFt Lease payments

Under IAS 17 the total of future non-cancellable operating lease payments should be noted in the disclosure under strict requirements (table 5.4). The minimal lease payments comprise “all the non-cancellable lease payments or payments that the lessee is obligated to make in connection with the lease property, excluding tax payable” (Lückerath-Rovers, 2007). Despite the requirements differences can be found in how corporates present their operating leases. Some AEX listed companies who also operate within the United States report not only under IFRS guidelines but also under FASB (SFAS 13) principles. These differences in disclosure impact the method of capitalisation. For corporations who respected the IAS 17 guidelines the minimal lease obligations for the years 1,2,3,4 and 5 should be estimated per calendar year before they can be capitalised. While for the SFAS 13 these minimal lease obligations are already given and therefore are more accurate.

<table>
<thead>
<tr>
<th>IAS 17</th>
<th>SFAS13</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 1 year</td>
<td>&lt; 1 year</td>
</tr>
<tr>
<td>1-5 Years</td>
<td>1-2 years</td>
</tr>
<tr>
<td>&gt; 5 years</td>
<td>2-3 years</td>
</tr>
<tr>
<td></td>
<td>3-4 years</td>
</tr>
<tr>
<td></td>
<td>4-5years</td>
</tr>
<tr>
<td></td>
<td>&gt; 5 years</td>
</tr>
</tbody>
</table>

Table: 5.4 Operating lease disclosure guidelines
Source: (Lückerath-Rovers, 2007)

Users of financial statements are heavily dependent on the information provided by the corporations. This information provision can be subdivided in the elements neutrality and completeness. Despite the strict guidelines related to operational lease presentation (table 5.4) various forms can be found in AEX annual reports. Notwithstanding the intention of lease accounting guidelines to uniform the data it may be clear that there is still a good deal of work outstanding in achieving this harmonisation / neutrality. The completeness of information is related to the willingness of corporations to provide additional information towards the operational lease disclosers. The transparency is therefore not solely related to the hard data provided but even more over dependent on the additional information provided. Figure 5.2 shows the operational lease disclosure of Heineken. If the lease obligations are evaluated it is striking to conclude that the lease obligations less than one year are €45 million and within 1-5 year it is just €2 million. This suggests that Heineken has lease contracts of less than one year assuming that the lease portfolio will be stable over time. Another explanation could be that Heineken has little insight and control over their lease obligations. Precisely then a substantiation of the differentiation within the operational leases portfolio regarding completeness is expected, instead of that Heineken stated: “Heineken...
Leases buildings, cars and equipment in the ordinary course of business” (Heineken, 2011, p. 134).

In contrast to Heineken, Airfrance-KLM (figure 5.3) is very transparent about their operational lease obligations. This is presumably related to the large amount of operational leases concerning their airplanes. Nevertheless, AirFrance-KLM is also extremely transparent in the CRE related leases. This makes making adjustments to operational lease more reliable.

Figure 5.2: Heineken off balance commitments
Source: Heineken Annual report (2011)

Figure 5.3: Operational lease commitments AirFrance-KLM
Source: AirFrance-KLM annual report 2011
As stated before, AEX listed companies, which report under IFRS, mostly provide minimum lease commitments in three tranches; less than one year, between one and five years and more than five years. Therefore, an assumption must be made for the lease commitments in year 2, 3, 4, 5 and beyond. Dividing the tranche 1-5 years by four would not be realistic. Instead of an equal division a unique digression factor (dg) depending on the lease pattern is determined (equation 5.6). The lease payments decrease at geometric rate and depend on the lease payments in year one. After year five the payments are equal as described in equation 5.6 (Angels et al., 2010)

\[ CF_{2 \text{ to } 5} = \sum_{t=1}^{4} CF_1 \ast dg \]

Equation 5.6: Lease payments for year 1-5
Source: (Angels, Soledad, & Neus, 2010)

5.2.3 Weighted total lease life

The weighted total life of the entire lease portfolio can be calculated as follows. The weight of each lease-expiration category is calculated by dividing the commitment of that particular expiration category by the total commitment (equation 5.7). This results in three weights, \( w_1, w_2, \) and \( w_3 \). These weights are used to calculate the weighted average remaining life, by multiplying each weight with the remaining life of each corresponding lease-expiration category (equation 5.8). The remaining life of the first lease-expiration category is one year, and for the second an average of three years is used. The remaining life of the third lease-expiration category is more complex. This differentiates companies with different payment schedules.

This thesis assumes that the total life is twice the weighted remaining life (in line with Imhoff et al. (1993) because no information is disclosed in the financial statements, which gives some indication of the real maturity of the lease. An equal division of remaining and passed maturity seems fair. (Lückerath-Rovers, 2007)

\[ W_e = \frac{CF_e}{\sum_{e=1}^{3} CF_e} \]

Equation 5.7: Lease Weight
Source: (Lückerath-Rovers, 2007)

\[ RL = W_1 \ast 1 + W_2 \ast 3 + W_3 \ast \left( \frac{CF_3}{CF_{yr5}} \right) + 5 \]

Equation 5.8: Remaining lease life
Source: (Lückerath-Rovers, 2007)
5.3 Model

Figure 5.4 provides an illustration of the final model that is applied to calculate the analysis for each corporation within the sample. The coloured boxes correspond to the coloured boxes in the model.

**Cft** Under IAS 17 the total of future non-cancellable operating lease payments should be noted in the disclosure under strict requirements (table 5.4). The minimal lease payments comprise “all the non-cancellable lease payments or payments that the lessee is obligated to make in connection with the lease property, excluding tax payable”. The payments are divided in tranches of leases than one year between 1 and 5 years and more than 5 years.

**The weighted total life** of the entire lease portfolio can be calculated as follows. The weight of each lease-expiration category is calculated by dividing the commitment of that particular expiration category by the total commitment (equation 5.7). This results in three weights, w1, w2, and w3. These weights are used to calculate the weighted average remaining life, by multiplying each weight with the remaining life of each corresponding lease-expiration category (equation 5.8).

**Cft** As stated before, AEX listed companies, which report under IFRS, mostly provide minimum lease commitments in three tranches; less than one year, between one and five years and more than five years. Therefore an assumption must be made for the lease commitments in year 2, 3, 4, 5 and beyond. Dividing the tranche 1-5 years by four would not be realistic. Instead of an equal division a unique digression factor (dg) depending on the lease pattern is determined (equation 5.6). The lease payments decrease at geometric rate and depend on the lease payments in year one.

**PVLL** The main purpose of the model is to determine the additional lease liability on the balance sheet also known as the present value of the lease liability (PVLL). The present value methods described in table 5.1 all calculate the PVLL by discounting the future operational lease obligations according the ‘constructive ILW capitalisation method’ (equation 5.1). This method captures the different timings of the lease liabilities and discounts the interest part, which is essential to determine the consequences under the proposed IFRS lease regulations.

**ROU** Under the SLE approach the amortisation of the ROU is a balancing figure to obtain the straight-line expense (ROU amortisation = cash flow straight line – interest expense). Since in our model the straight-line expense does not deviate from the actual cash flow (due to the tranche principle) the ROU asset remains equal to the PVLL.

The described tranches-principle (figure 5.4) is used for the cash flow, present value of the cash flow, present value of the lease liability (PVLL) and the right of use asset (ROU). Example 5.4 is specific for CRE related leases (SLE approach), the total model (appendix III) includes a model with a similar lay-out but then adapted for non-real estate operational leases (I&A approach). Subsequently the total model is equipped with a separate cockpit to insert input variables as described in section 5.2.2 and an output overview where the results are presented.
Model example

5.2.2 Cft lease payments (equation 5.6)  
5.2.3 Weighted total lease life equation (5.7 & 5.8)  
5.1.2 Right of use asset (equation 5.2)  
5.1.2 Capitalisation lease liability (equation 5.1)
5.4 Impact study

Various studies and reports estimated the impact of operational capitalisation, each of these reports concluded that the impact of active capitalisation of operational leases would be significant. But none of these reports emphasised on the CRE related impact. Within this thesis the contribution of CRE is distilled and put in context of the total impact. Before doing so, it is good to know that because of the detailed analysis the sample size is limited to 23 AEX listed companies, it is therefore hard to make specific sectors or industries statements. Nevertheless, these 23 AEX listed companies together have more than 25 billion non-cancellable future lease obligations. None of these lease obligations are currently activated on the corporations’ balance sheet. Before the actual impact of the new IFRS lease accounting regulations is determined, the lease portfolio and the amount of CRE on corporation’s balance sheets were analysed. Figure 5.4 shows that the amount of operational leases differs strongly per corporation. Generally, the greater part of the operational leases obligations is traceable to real estate leases. These operational leases, which are not activated on the balance sheets, are responsible for average 74% of the total lease portfolio. In other words 74% of the lease liabilities are not traceable corporations’ balance sheets. Another surprising element is the total amount of real estate and land in relation to the total assets. Various studies\textsuperscript{46} make statements over the significant amount of real estate on corporates balance sheet. However when the data from AEX listed corporations is analysed an average of just 7% of the assets\textsuperscript{47} can be related to real estate and land. Obviously the amount differs strongly from corporation to corporation, outliers are Ahold, and Shell with 23% and 25%, nonetheless these findings are discrepant to previous findings. An explanation for this huge difference with previous studies might be the method how real estate and land are counted on the balance sheet. AEX listed companies add their real estate and land in general for their book value to their assets instead of market value. Therefore the amount could be lower, but it is still a remarkable difference compared to previous findings.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure5_5}
\caption{Proportion of property and land}
\end{figure}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure5_6}
\caption{Finance leases versus operating leases}
\end{figure}
In relation to the analysis of the portfolio the average total lease life for CRE related operational leases is determined. The longer the lease term the more lease obligations has to be capitalised. However the added lease liability is determined by the effective interest method. Thereby the magnitude of impact of leases in the far future have less impact than lease obligations of tomorrow. Notwithstanding, the lease term is one of the ten management buttons described in chapter 4, active management to shorter leases might result in less impact. The average lease term of CRE related within the AEX sample is 8.67 years.

5.4.1 Income statement and balance sheet impact
Capitalising the operating lease obligations and bringing them on balance affects two major components e.g. assets (figure 5.5) and liabilities (figure 5.4). The I&A approach (non CRE leases) in addition impact the income statement as well. The green bars represent the impact caused by capitalising the CRE related leases. The blue bars reflect the total increase and sets the CRE impact in perspective to the total impact. The impact is not only related to the additional amount of operational leases either is also dependent of the total amount of assets and liabilities. Benchmarking corporations one on one is therefore meaningless, since all components are subsidiary to a specific sector or business model. This was either not the purpose of the macro analysis. The main goal is to understand what the potential impact will be and to make a rather technical principle comprehensive. In addition to the sample impact the median is determined to understand what the overall impact will be, an average would give distorted picture since the many outliers.

The corporations that score above the median are not immediately in the danger zone. The potential impact could be explainable to the business model or sector where it operates. Ahold is for instance exposed to the highest impact by far, is this impact concerning? Probably not since Ahold’s core business (retail) is distinctive to the high need of retail leases. It becomes interesting when the impact for Ahold is significantly higher than for Jumbo. Nevertheless, if the impact cannot be related to a higher need to (CRE) operational leases originate from the business model of sector it might be a reason to raise questions.
As previously described Ahold has as a retail organisation the highest CRE related impact with an increase of 36% of the total liabilities. This increase is caused by the large amount of retail leases and their renewal options. The impact for retail an organisation such as Ahold is seems to be inevitable but not unexpected. AirFrance-KLM, Fugro and TNT are exposed to high total impacts which is for the greater part caused by the operational leases of aircrafts and freighters. If the highly impacted corporations (retail, airplanes and freighters) are extracted from the sample the outcome becomes more interesting. The corporations that are subjected to more impact caused by CRE than the median are Akzo Nobel, PostNL, Randstad, Reed Elsevier and TNT. This impact is especially surprising for PostNL, and Randstad considering their relatively short lease terms. Additionally these corporates are not directly linked to sectors with a high need of CRE. Apparently, Randstad and PostNL have a relative high operational lease exposure in comparison to their outstanding liabilities. Therefore the potential impact on their balance sheet is significantly higher than for remainder of the AEX sample. The financials e.g., Aegon and ING, survive the potential introduction unimpaired due their enormous amount of financial assets and liabilities on their balance sheets. The impact of additional leases is therefore negligible.

The impact on assets (figure 5.4) is for the greater part comparable to the impact on liabilities- with a few exceptions. As with the liabilities PostNL and Randstad are exposed to more impact than the median of the sample. For TNT Express, ReedElsevier and AkzoNobel the impact on assets seems to be less than for the liabilities. But now Unliver pops-up as a corporate with a relatively high impact on balance sheet assets.

The change in equity is due to our method (conservative assumption) is only caused by the non-real estate operational leases. In particular corporations with relative high I&A lease exposure encounter equity adjustments e.g. AirFrance-KLM, TNT Express, Fugro. Furthermore, the increase of leases on the balance sheet is tremendous and varies from 37165% for Aegon by 8% for SBM offshore. This huge deviation is explainable by the structure of the lease portfolio. Aegon, for instance, possesses almost solely operational leases. When these leases are activated on the balance sheet the potential increase is immense. For SBM offshore the majority of the lease portfolio consists of financial leases and is therefore already activated on the balance sheet.

![Increase liabilities](image)

*Figure 5.8: Balance sheet impact liabilities*
5.4.2 Financial ratios

Financial statement users use financial ratios and micro value drivers to measure the financial strength and risk of a corporation. Ratios are used to standardise financial measurements in order to compare corporation’s profitability and risk. A comparison between high and low exposed lease corporations would be unfair if ratios are determined without an adjustment of the off balance lease liabilities. Secondly it makes corporations that acquire CRE more comparable to corporations that prefer leases. (Lückera Rovers, 2007).

In the macro analysis the impact of a divers spread of ratios (table 5.5 is calculated. The table gives an overall overview which ratio’s change relating towards CRE and the total impact. It does not mention the exact change per corporation, this is also not essential to understand the impact and it does not improve the readability. Appendix IV can be consulted for more detailed information per corporation. Notwithstanding the two most important ratios that significant changes due CRE, leverage and return on assets, are extensively described further on in the section.

It is good to understand that an increase of a ratio does not correspond to a positive impact. An increase of the leverage ratio for example means a decrease of the creditability. Overall, the leverage and return on assets are the most important ratios that are significantly affected by capitalisation of CRE related operational leases. The total impact incorporates the I&A approach which also affects the equity position. The ratios that solely change for the total impact are thus related to equity changes. Contrary to all other ratios the EBIT\textsuperscript{48} and EBITDA\textsuperscript{21} improve. This is caused by the I&A approach (non-real estate leases) which splits a lease liability from a former operational cost item, in to an amortisation and interest expense which are not incorporated in the EBIT and EBITDA amount.

Figure 5.9: Balance sheet impact assets
As mentioned before, the most structural changes are noticed for the leverage and the return on assets position. For this reason these ratios are discussed more comprehensibly. Changes in ratios are not only dependent on the additional amount of operational leases but to more extend sensitive to the relation of those lease obligations to the total assets / liabilities.

The debt to equity ratio –also known as leverage or gearing, is one of the most important ratios used by rating agencies to measure the financial health/risk of a corporation. Especially lenders and banks use this ratio to determine the debt capacity and the ability to repay debt. This ratio is therefore commonly included within debt covenants. If corporations exceed the range that is determined in the debt covenants this in general has financial consequences. Therefore a significant change could result in a serious compliance issue relating to debt-covenants, which have to be renegotiated. The higher the ratio the more outstanding liabilities in relation to the equity position. The I&A approach will impact corporations with a relatively high amount of operational leases more severely, since the I&A approach affects the liabilities and the equity position. Another ratio that is especially important to shareholders is the Return on Assets (figure 5.11). This ratio gives insight in the profitability of a corporation- relative to the total assets. Since the total assets are the denominator in the calculation this ratio will decrease by active capitalization of the operational lease obligations. Unlike leverage, the impact on ROA will be most severe for corporations with a relatively high amount of operational lease liabilities relative to its assets.

Ratios consist of hard data which vary from corporation to corporation and industry by industry. Therefore the change is given in exact data -current and potential- supplemented with the percentage of change (table 5.6). The change in percentages is given in figure 5.10 and 5.11 to make the impact more comprehensible.
Subsequently, the impact is relatively high for AirFrance-KLM, TNT and Fugro because their huge amount of I&A exposure to airplanes and freighters. Self-evident, Ahold will suffer also with an increase of 38.8% in total which for the greater part is related to CRE. On average the increase is 10.2%, due to the big outliers a median gives more inside. The median impact on leverage is an increase of 4.33%. AirFrance-KLM, KPN, Shell, Fugro and TNT Express suffer mostly by their non-real estate leases. For Ahold, AkzoNobel, PostNL, Randstad and Reed Elsevier the impact is higher than the median and directly related to the CRE leases. Where for Ahold and Akzo Nobel the impact is traceable to the need and amount of CRE, the impact for the other corporates is less evident.

Table 5.6: Leverage impact

<table>
<thead>
<tr>
<th>Company</th>
<th>Leverage current</th>
<th>CRE current</th>
<th>Total current</th>
<th>Return on assets current</th>
<th>CRE current</th>
<th>Total current</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aegon</td>
<td>12.43</td>
<td>12.44</td>
<td>12.43</td>
<td>12.45</td>
<td>0.27%</td>
<td>0.27%</td>
</tr>
<tr>
<td>Ahlhold</td>
<td>1.55</td>
<td>2.11</td>
<td>1.55</td>
<td>2.15</td>
<td>8.20%</td>
<td>6.72%</td>
</tr>
<tr>
<td>AirFrance-KLM</td>
<td>3.48</td>
<td>3.59</td>
<td>3.48</td>
<td>4.90</td>
<td>-3.06%</td>
<td>-2.98%</td>
</tr>
<tr>
<td>Akzo Nobel</td>
<td>1.04</td>
<td>1.09</td>
<td>1.04</td>
<td>1.10</td>
<td>3.87%</td>
<td>3.78%</td>
</tr>
<tr>
<td>Aperam</td>
<td>0.91</td>
<td>0.92</td>
<td>0.91</td>
<td>0.92</td>
<td>-1.07%</td>
<td>-1.07%</td>
</tr>
<tr>
<td>ASML</td>
<td>1.03</td>
<td>1.07</td>
<td>1.03</td>
<td>1.07</td>
<td>21.40%</td>
<td>21.05%</td>
</tr>
<tr>
<td>Arcelor Mittal</td>
<td>1.02</td>
<td>1.02</td>
<td>1.02</td>
<td>1.04</td>
<td>0.10%</td>
<td>0.10%</td>
</tr>
<tr>
<td>Boskalis</td>
<td>1.67</td>
<td>1.69</td>
<td>1.67</td>
<td>1.71</td>
<td>4.07%</td>
<td>4.05%</td>
</tr>
<tr>
<td>D.E. Master Blenders 1753</td>
<td>5.87</td>
<td>6.00</td>
<td>5.87</td>
<td>6.04</td>
<td>4.08%</td>
<td>4.00%</td>
</tr>
<tr>
<td>DSM</td>
<td>0.87</td>
<td>0.88</td>
<td>0.87</td>
<td>0.88</td>
<td>6.90%</td>
<td>6.87%</td>
</tr>
<tr>
<td>Fugro</td>
<td>1.31</td>
<td>1.35</td>
<td>1.31</td>
<td>1.57</td>
<td>9.98%</td>
<td>9.81%</td>
</tr>
<tr>
<td>Heineken</td>
<td>1.69</td>
<td>1.72</td>
<td>1.69</td>
<td>1.72</td>
<td>7.23%</td>
<td>7.15%</td>
</tr>
<tr>
<td>ING</td>
<td>24.36</td>
<td>24.38</td>
<td>24.36</td>
<td>24.39</td>
<td>0.61%</td>
<td>0.61%</td>
</tr>
<tr>
<td>KPN</td>
<td>6.64</td>
<td>6.75</td>
<td>6.64</td>
<td>7.55</td>
<td>8.20%</td>
<td>8.08%</td>
</tr>
<tr>
<td>Philips</td>
<td>1.34</td>
<td>1.38</td>
<td>1.34</td>
<td>1.40</td>
<td>-1.67%</td>
<td>-1.64%</td>
</tr>
<tr>
<td>PostNL</td>
<td>8.95</td>
<td>9.41</td>
<td>8.95</td>
<td>9.80</td>
<td>60.38%</td>
<td>57.67%</td>
</tr>
<tr>
<td>Randstad</td>
<td>1.68</td>
<td>1.82</td>
<td>1.68</td>
<td>1.86</td>
<td>2.92%</td>
<td>2.78%</td>
</tr>
<tr>
<td>Reed Elsevier</td>
<td>4.23</td>
<td>4.41</td>
<td>4.23</td>
<td>4.43</td>
<td>4.69%</td>
<td>4.60%</td>
</tr>
<tr>
<td>SBM offshore</td>
<td>3.07</td>
<td>3.08</td>
<td>3.07</td>
<td>3.22</td>
<td>-1.28%</td>
<td>-1.28%</td>
</tr>
<tr>
<td>Shell</td>
<td>1.02</td>
<td>1.04</td>
<td>1.02</td>
<td>1.11</td>
<td>14.50%</td>
<td>14.32%</td>
</tr>
<tr>
<td>TNT Express</td>
<td>0.67</td>
<td>0.70</td>
<td>0.67</td>
<td>1.07</td>
<td>-4.24%</td>
<td>-4.16%</td>
</tr>
<tr>
<td>Unilever</td>
<td>2.18</td>
<td>2.25</td>
<td>2.18</td>
<td>2.26</td>
<td>33.71%</td>
<td>31.97%</td>
</tr>
<tr>
<td>Wolters Kluwer</td>
<td>3.29</td>
<td>3.32</td>
<td>3.29</td>
<td>3.35</td>
<td>7.56%</td>
<td>7.56%</td>
</tr>
</tbody>
</table>
Return on assets is especially important for shareholders. This ratio gives insight in the profitability of a corporation relative to the total assets. Since the total assets are the denominator in the calculation this ratio will decrease by active capitalization of the future lease obligations. In contradiction to leverage the impact will be most severe for corporations with a relative high amount operational lease liabilities relative to the assets instead of liabilities. Also, the impact of I&A leases is lower than for SLE leases. As described the I&A approach splits the operating expense into an amortization and interest part. Therefore the EBIT will increase over time since the interest part steadily decreases (front-end loaded).

Financial ratio’s change significantly either not consequent at the same rate for each corporation. Investors, lenders and rating agencies need to update their performance ratios in order to reassess and benchmark corporations to the financial risk and creditworthiness.
5.4.3 Real Estate Lease (REL) ratio

In addition to the commonly used ratios—this thesis introduces a new KPI; the Real Estate Lease (REL) ratio. Until today there is no ratio or benchmark that can be used to compare high and low lease exposed corporations. To amplify the awareness of transparency for (CRE) related operational leases the REL ratio is introduced in order to make comparisons accessible. The CRE lease exposure is constructed by dividing the total of real estate related operational leases liabilities by the total assets. Herewith it becomes apparent in what extend corporations are exposed toward CRE related leases. It must be stated that the ratio is determined for the total assets, which includes inter alia ‘goodwill’, ‘inventory’ and ‘current assets’. For a constructive analysis these elements could be extracted from the ratio, which makes the ratio more useful for financial comparability. Subsequently it will be more profound to compare corporations within an industry sector since the sector largely determines the need for CRE leases. Interestingly is to compare this ratio with the earlier discussed figure 5.5 which reflected the ownership exposure of CRE. These ratio cannot be compared one on one either it gives insight in the composition of a CRE portfolio, Shell, Aperam, Arcelor Mittal and Heineken have relative more CRE ownership in their portfolio vs. CRE related operational leases. This is not surprising since the specific CRE characteristics for this industry. For Heineken the relative large amount of ownership is probably a heritage from historic developments. Subsequently ASML, Randstad PostNL and AirFrance-KLM have obviously more CRE leases.

CRE operational lease exposure

In addition figure 5.13 sets out the CRE lease exposure figure 5.12 towards the average lease life. The slope of this line will form the REL ratio. For figure 5.14 Ahold is left out consideration since this corporation is a heavy outlier. This emphasises the huge difference in amounts of CRE related lease exposure. The combination of figure 5.12 and 5.13 gives a good insight in how a CRE lease portfolio is composed. It reflects the relative size of a lease portfolio towards and puts the expose in perspective of average lease life, which illustrates a certain type of flexibility. A remarkable observation is that ASML has a relative high CRE lease exposure with relative low average lease life where you should expect longer lease terms since the specific characteristics of ASML’s CRE assets.
**Operational lease versus the average lease term**

Figure 5.13: CRE related operational leases versus the lease term

**Operational lease versus the average lease term; without Ahold**

Figure 5.14: Operational leases versus the lease term without Ahold
5.4.4 Consequences relating financial statement users
An important question is to what extent will changes in ratios impact debt covenants, investment decisions and credit ratings? If loan officers, shareholders and analysts do not adjust ratios for operational leases, decisions should be affected (Wilkins & Zimmer, 1983). Assuming that all professional stakeholders adjust for the operational lease disclosures, as is done in this macro analyses, which is a quite conservative way of thinking according to Lückerath-Rovers (2007) and it is therefore argued that the capitalisation of operational lease will have no impact on the decision-making. Taking in account that the level of adjustments vary strongly from multipliers to more detailed capitalisation approaches. All of these approaches are for the greater part based on assumptions. The correction is therefore never more than a well educated guess. For corporations that are transparent in their lease liabilities and provide solid information this ‘well educated guess’ will probably be more representative for the actual lease liability. Nevertheless, this difference in impact will probably not be that significant it will change stakeholder decisions.

There are however some ‘hidden flaws’. As Standard and Poor’s (2010) stated, they do not think they would adapt ratings since they already make adjustments. But there are some indirect effects then they will more likely change the risk profile of corporations. IFRS lease accounting obligates corporations towards more transparency, which will lead to more accurate lease datasets for many issuers. Standard & Poor’s expects these new requirements lead to significant new / additional lease liabilities that where not communicated in previous discloreses. In addition the supervision by auditors will increase since operational leases are ranked up from ‘disclosure issue’ towards full accounting on the balance sheet. According to Standard & Poor’s the increase of supervision will more often lead to a downgrade in creditability, let alone a total revision of the lease portfolio. This will not be limited to credit rating agencies since capital suppliers will also respond to additional information. This may result in compliance issues with debt covenants, which will, thereupon, affect the the borrowing capacity of these corporations. (Standard & Poor’s, 2010)

5.5 Conclusion
This chapter examined the potential impact of the new IFRS lease accounting regulations and the contribution of CRE to this impact. There are various methods to examine the potential impact, varying from rules of thumb like eight times the operational lease commitments to more in-depth analyses e.g. (Imhoff et al.,1991). But operational lease disclosures lack in providing sufficient required information in order to fulfil an accurate adjustment (Lückerath-Rovers, 2007). Adjustments are therefore in the end not more than a well educated guess: since the outcome is highly reliable on the input variables. Therefore only the corporates themself can give an accurate insight in the future liabilities. Prior to the actual analysis two observations where striking; in contradiction to previous studies, the amount of real estate and land on AEX listed companies’ balance sheets seems to be much lower than expected. For the AEX sample used within this study the average real estate exposure is just 7% of the total assets (figure 5.16). This could be caused by the method that is used for determining the value. Notwithstanding, this is still a remarkable difference compared to previous findings. In addition 74% of the lease portfolio consists of operational leases (figure 5.15). Irrespectively whether these leases are knowingly structured as operational lease or not: it is hard to justify that presenting just 26% of the total lease liabilities on the AEX corporate balance sheets’ are transparent. In addition, the difference between financial leases and operating leases can be rather small and arbitrary (hence the bright-line test); but the difference in accounting treatment is immense, which can be compared to the contrast of black and white.
The macro analysis is limited by the assumptions that have to be made. Consequently, the macro analyses cannot claim to represent the actual impact, as the adjustments by other stakeholders in this macro analysis is more like a well educated guess. However, assumptions are made conservatively so the impact is potentially higher than represented within this chapter. It was never the intention to benchmark corporations with regard to each other, but the analysis gives a good insight in which corporations potentially will be impacted the most. But even more importantly it helped to encompass the highly technical subject of IFRS lease accounting and made the contribution of CRE apparent.

In first instance the CRE related impact seems to be significant, especially for corporations with a high retail lease exposure like Ahold. Also corporations with a large exposure to leases related aircrafts and freighters e.g. AirFrance-KLM, Fugro and TNT are subjected to the magnitude of IFRS lease accounting. For these corporations the impact is inevitable due to their business model. These findings correspond to previous studies in the U.S., Germany and Spain (Canon & Fenbert, 2011; Fülbier et al., 2006 and Angels et al., 2010). Subsequently the analysis illustrates that the relative impact of the proposed lease accounting changes is less severe than was expected and emphasised that the greater part can be traced back to CRE leases. The median impact seems not to be that significant; however it will form a new benchmark. Corporations which are exposed to a higher impact than the median (table 5.14) would have to be able to explain 'why'.

The introduction of the REL made comparison of different corporations more accessible. But due to the different business models and industries it is hard to compare the 23 corporations with each other, which is directly the limitation of this study. It would be more realistic to compare corporations within a specific industry. For example; if the impact is significantly higher for KPN than for Vodafone or T-Mobile then stakeholders should raise questions. This
thesis created a starting point either a CRE industry benchmark in relation to IFRS lease accounting and leases would therefore be a logical step.

Although the impact seems to be denser than expected, it should not be underestimated. IFRS lease accounting affects the most trivial financial ratios. Since these ratios play an important part in the decision making of lenders, rating agencies and shareholders, corporations tend to mitigate the impact as much as possible. Especially corporations that endure more impact than comparable corporations within the industry could expect additional questions from stakeholders. Probably the capitalisation of the operational leases in the disclosures will not be the major issue, since professional stakeholders already adjust these for operational leases, which is a quite conservative way of thinking according (Lückerath-Rovers, 2007). However, more important are the additional leases that become apparent by new data systems, more control of auditors or more accurate adjustments. Consequently corporations that are not in full control of their lease portfolio or are not transparent in their current disclosures could potentially be confronted with downgrading by rating agencies, and changing investment decisions by shareholders.

Additionally a serious consequence of the lease accounting implementation is the compliance issues with debt covenants, especially when additional information becomes visible. Before renegotiation it is essential to understand what and why companies have a particular lease portfolio, predict what the impact will be and prepare to reduce the impact if necessary. Since the greater part of the impact is related to CRE leases these are also the leases wherewith the impact could be influenced the most. It would therefore not be unthinkable that corporations will use the ten management buttons described in chapter 4 in order to mitigate the impact. Especially for corporations with stressed financial positions the management buttons are a welcome tool for corporate executives to reduce the impact of IFRS lease accounting.
What is the market expecting?

Previous chapters were dominated by theoretical theories and assumptions. This chapter will, in contrast, test the assumptions and theoretical implications by answering sub-question 5; “What are the practical implications of the lease capitalisation for AEX corporations?”. Section 6.1 discusses the conducted survey under the 8 AEX listed corporations and displays the results in the Joroff-model. Subsequently, the results from Chapter 5 are discussed, by means of interviews, with CREM divisions of eight AEX listed companies (§6.2). Section 6.3 discusses interviews with several other stakeholders to provide a complete picture. Furthermore, two hypothetical situations are outlined to model possible future situations concerning CREM considerations (§6.4). Finally, section 6.5 reflects the most important findings and concludes this chapter.

This chapter describes the qualitative research that is conducted in order to be able to answer the research question. This qualitative research has the main goal to test the theoretical assumptions discussed in the chapters 2, 3 and 4 in order to determine to which extent the theoretical framework can be translated into practical implementation effects; in particular the practical usefulness of the ten management buttons and the different impact on each CREM division determined by their place on the Joroff-model. Two stages comprise this qualitative research due to practical considerations; a survey and an interview.

6.1 Survey

Three premises have to be clear to be able to make statements about a possible change in decision-making processes; 1) the stage on the Joroff-model on which the particular CREM division operates, 2) the CRE strategy, and 3) the input variables that were used in the macro analysis for calculating the possible impact on the corporate KPIs. This data had to be retrieved before conducting the interviews simply to be able to classify the CRE strategy of all CREM divisions on an equal basis, to position the CREM divisions on equal premises in the Joroff-model and to be able to calculate, in advance, the impact on their KPIs to confront the interviewees with the –in some cases worrisome- outcomes of the macro analysis.

The survey was published in the form of an online questionnaire and consisted of seven parts and overall comprised 32 questions (appendix V). The seven parts are:

1. Participant; in order to get to know the awareness of the lease accounting project
2. Characteristics of your organisation; verification of the value of the CRE portfolio, the size of the CRE portfolio, the number of assets and the leased versus the owned assets ratio.
3. Portfolio structure; verification of the percentage of assets that comprises the CRE portfolio.
4. Lease obligations; verification of, inter alia, the total amount of CRE finance/operating lease obligations of the corporation.
5. Activities of your corporate real estate organisation; a set of questions to find out if a CREM division was present, to find out to which board member the CRE manager reports, and to qualify the stage of the CREM division on the Joroff-model.
6. Identification of the corporate real estate strategic motivation; the qualification of the CRE strategy.
7. Follow-up interview; the question to find out if a follow-up interview is possible.

Some of the assumptions of the macro analysis had to be verified in the survey since not all the necessary input variables are available in the corporate financial statements. This data was retrieved with parts 2, 3, and 4. The determination of the place of the CREM division in the Joroff-model was verified by two separate methods. First, a description per stage of the Joroff-model was posed whereby each CRE manager could tick a box which described the ‘identity’ of their CREM department. Second, a list of activities was posed whereby each CRE
manager could select activities that where performed by their CREM division. These two methods were based on a study conducted by Mattousch (2010). Mattousch (2010) linked specific activities with a specific stage of the Joroff-model. Subsequently, a double check was possible since the selected activities should correspond with the selected description (part 5). Furthermore, the online questionnaire provided a first opportunity to monitor the awareness of the CRE managers of the proposed changes to lease accounting (part 1) and to qualify their CRE strategy (part 6).

The following descriptions and corresponding activities were used in the survey, these descriptions and corresponding activities are based on previous research conducted by Matousch (2010). As mentioned in chapter 3, the transition to the next phase on the Joroff-model implies that CREM divisions are fully aware of and capable of executing the activities connected to previous phases.

<table>
<thead>
<tr>
<th>Description</th>
<th>Activities</th>
</tr>
</thead>
</table>
| Strategist  | - Naming principles and frameworks for property management.  
- Advise business units in their housing needs/space requirements  
- Establish frameworks serving internal real estate decisions |
| Entrepreneur | - Buy/sell analysis: preparation of (dis)investment proposals in line with the portfolio policy  
- Drafting of framework contracts with suppliers  
- Prepare and coordinate a proactive acquisition plan/disposition plan  
- Naming principles and frameworks for property management. |
| Dealmaker   | - Performance analyses  
- Producing a strategic real estate plan and translate it into a concrete property plan |
| Controller  | - Contract / legal management: processing leases, financial management, collecting of internal rents, collecting object data in a building information system |
| Taskmaster  | - Performing (or outsourcing) technical management: long-term maintenance, maintenance inspections and systematic maintenance. |

The online survey was send to 23 of the 25 AEX publicly traded corporations. Corio and Unibail Rodamco were left out of scope because real estate is their core business and do, therefore, they do not meet the requirements. Seven corporations fully answered the online questionnaire. In addition, three corporations were open to participate in an interview whereby the survey was covered within the interview. The remaining companies were not able to fill out the questionnaire or to participate in an interview because they, for example; lacked a CREM department, were not allowed due to their corporate policy to participate, or just did not respond. The most interesting conclusions that could be drawn from the filled out surveys presented in the following figures:
One would expect every AEX publicly traded company to have a CREM division but this appears not to be the case. At one corporation Facility Management (FM) controls their CRE at a local level. Subsequently there is a wide variety noticeable under which supervision CREM belongs. There are two mainstream flavours, on the one hand five corporates who classify CRE as a financial asset and therefore report towards the CFO and on the other hand four corporations where CRE is much more seen as business resource that contributes to the business process. This last perspective reports mainly towards the COO. One corporation that participated the survey had no CREM division at all; in this particular case the local facility managers are responsible for the CRE and report to their location director.

The proposed IFRS lease accounting guidance is not common knowledge for at least five CREM divisions. Five CREM divisions state they are fully aware of the proposed changes. Three CREM divisions argue to be globally informed about IFRS lease accounting and two CREM division are not or only scarcely to aware of the proposed changes. Furthermore almost half the sample that filled out the online questionnaire did not know what possible impacts of the proposed changes to lease accounting would involve for their CRE division. Six CREM divisions argue to be fully informed about the possible impact of the proposed changes. One CREM division states that they are globally aware of the possible impacts and two CREM divisions are not aware of the possible impacts. Another important aspect of the IFRS lease accounting implementation is data management. Four of the survey participants did not know, at least a part of, the requested data even though it was available in their financial statements. Mainly the data regarding operational and financial leases formed an obstacle for four of the respondents. Followed by three corporations that could fully fill out the questionnaire and were, thus, fully aware of their CRE portfolio data. For the macro analysis it was necessary to determine the corporate WACC in order to capitalise the future lease obligations. The corresponded WACC in the survey ranged from 7% till 11%. Whereby three CREM divisions did not know what their WACC for their business unit was.
The second part of the survey emphasised the strategic characteristics of the CRE and CREM. Important aspects hereby are the seven alternative strategies derived from chapter 3. The survey asked the participants to what extend they could reflect their CREM division with statements relating towards the seven alternative strategies. Main objective was to determine the most important strategic drivers towards CRE. It is good to understand that none of the corporations had one specific value driver that was dominant in their CRE strategy. Overall the CRE strategies are a mix of the seven alternative strategies whereby the weight per aspect differs. Notwithstanding that the sample size was limited to ten respondents, it is remarkable to notice in that the two Exchange values ‘reducing costs’ and ‘flexibility’ are rated as the most important aspects within the CRE strategy (Figure 6.2). Previous studies e.g. Nourse & Roulac (1993), Ramakers (2008) and Scheffer et al. (2006) describe that CRE strategy can almost be seen as ‘delineated boxes’, however in practice strategies are virtually always a combination of those ‘boxes’.

Figure 6.2 Overview survey results strategic driver

Regarding the Jorrof stages and corresponding activities, it was remarkable that the activities that the CREM divisions argued to perform did often not correspond with the identification they suggested for their division. Notwithstanding, the results of the survey led to the classification of the CREM divisions in the Joroff-model as figure 6.1 illustrates. Appendix VIII shows a more detailed overview of the activities and identities of each individual CREM department. Additionally, a motivation is provided to support the motivation for the position of a specific corporation on the Joroff-model.

Figure 6.1: 23 AEX listed corporations incorporated in the Joroff-model
6.2 Interviews with CREM divisions

Once the results of the online questionnaire were analysed, in-depth interviews were conducted with CREM divisions of AEX publicly traded companies. The goal of the interviews is to capture the vision of CRE managers of AEX publicly traded corporations with various backgrounds to what extent they will apply changes to their daily practices due to the IFRS lease accounting changes. In order to be able to capture this view, the interview (appendix VI) is organised in five parts; 1) ‘introduction’, 2) ‘data management’, 3) ‘transaction management’, 4) ‘portfolio management’, and 5) ‘in addition’. The ‘tailor-made’ introduction comprised of the outcomes of the survey and the macro analysis that acted as a guide during the interviews. IFRS lease accounting appeared to be, as the results of the survey showed, still a rather subjective element for most corporations. It was, therefore, useful to make this subjective element more tangible in the form of hard data specified per company, as calculated in chapter 5. The interview questions that were asked to capture the vision of the CRE managers concerning the possible impacts of IFRS lease accounting on their CRE strategies and CRE decision-making are subdivided, in line with the theory of section 4.2, in the trichotomy; data management, transaction management, and portfolio decision-making. This structure was used for each interview to provide a framework to discuss the ten management buttons, illustrated in figure 6.2, in a random order.

The fifth part, ‘in addition’ was used for additional remarks or firm specific questions that were added. This section links, thus, the practical implementation of the theoretical management buttons framework with the outcomes of the macro analysis and the views of the AEX listed companies.

6.2.1 Sample & facts

Five of the seven corporations that answered the online questionnaire, were willing to participate in an interview. In addition, three corporations were open to participate in an interview whereby the survey questions were covered within the interview. Thus, in total the interviewed sample consists of eight AEX listed corporations which altogether represent 50% of the total CRE related operational leases and 74% of the total amount of on-balance recognised property and land of the 23 publicly traded AEX corporations. This is illustrated by the figures 6.3 and 6.4.

In the three sections that follow, the theoretical assumptions of the previous chapters are examined and provide evidence collected through the subject interview process. Quotations of the interviews in the next sections are shown on an anonymous basis in order to secure the sensitive information of the corporations that participated, the whole -not anonymised-
interviews can be found in appendix VII. The quotations, however, do provide a clear picture of the real estate industry as to how and to what CRE decisions would change, or at least be influenced, by the proposed changes to lease accounting. It should thereby be noted that sample size for this study is not necessarily representative for the entire population of Dutch CRE users. Rather, these interviews explore whether certain company or portfolio characteristics may increase the likelihood for changes in the CRE decisions-making process in response to changes in accounting requirements and whether the interviewees support the findings of the previous chapters of this thesis.

6.2.2 Interview part 1: Introduction
It could be stated that virtually all the interviewees agreed with the place assigned of their CREM division on the Joroff-model. This was, however, not the case with the outcomes of the macro analysis. Many interviewees responded differently, for example; some interviewees did not know what the numbers implied, and others were triggered by the possible impact or did know that that the input variables could be extracted from their corporate financial statements. This created an interesting framework for the interview and provided data to make suggestions tangible. It was, thereby, interesting to notice that only a few of the interviewees did have enjoyed a study real estate and the background of each person was very diverse.

6.2.3 Interview part 2: Data management
Chapter 2 stated that the IFRS lease accounting proposal stipulates that all operating leases should be capitalised using the PV of expected lease payments. Therefore, it is argued that CRE managers will first need to catalogue existing leases and gather all available data about all ten management buttons, illustrated in figure 6.2, to be included in the financial statements. Most pressing questions were therefore; “How is your data concerning CRE managed; e.g., centrally in a data system, de-central in Excel or de-central by an outsourced system?”, “Do you know what the required data is concerning IFRS lease accounting implementation?”, and “Is the necessary data available?”. When the first question is analysed it can be argued that the CRE data management of the AEX publicly traded companies is, as can be expected, arranged in a variety of ways. This was also the case with the CREM divisions of the interviewees. The degree of professionalism varied from; managing the CRE data decentralised in Excel using different methods and accounts in each country that one operated in, to the data management of hundreds of CRE locations organised in one centralised data system that is externally bought and already updated for the needs of the implementation of IFRS lease accounting. This is an interesting observation and it was used to place the other data management questions into perspective. Subsequently, the second question; “Do you know what the required data is concerning IFRS lease accounting implementation?”, was addressed and showed that there were several interviewees that were not aware of the upcoming necessary data provisions and interviewees that were familiar with the lease accounting proposals. With virtually all CREM divisions that managed their CRE decentralised it was the case that they are not aware of the data entries that are required for implementing the proposed lease accounting guidance and this was confirmed during the interviews.

“The implementation of the new IFRS lease accounting standard is argued for this corporation not to be an objective for the CRE department. After all it is in essence accounting regulation and this CRE department assumes that the corporate control department is fully aware of the possible impact.”

It was thereby the case that the interviewees that acted on the ‘Strategist’ level of the Joroff-model had more professionalised data management systems and were more aware of the upcoming IFRS lease accounting guidance, and thus more prepared, than the companies operating at the lower levels of the Joroff-model. This does however not mean
that this holds for the remaining AEX listed corporations that were not interviewed, illustrated by the following quotes of two different ‘Strategists’;

“Despite the fact that the regulatory issues are not active yet we already report with and without the lease accounting standard.”

“The proposed changes were not on the corporate agenda till January 2013.”

Raising the third question about the availability of the necessary data led to very different answers. The interviewees that managed their data centralised had all the data about the ten management buttons available or could easily retrieve data if some parts were missing. Several interviewees indicated that had already begun with the implementation process to prepare for the new guidance, such as making changes to their IT systems, others indicated that they had set the preparations on-hold, because of the continuous delay of the implementation date. The management buttons that were mostly not present in these current overviews were; 1) the discount rate, 2) the purchase options, and 3) service contracts. These ‘missing’ buttons could, however, easily be retrieved. The interviewees that managed their data decentralised lacked more management buttons that could, moreover, not be easily retrieved. These interviewees admitted to realise that their current data systems lack detailed lease information, especially concerning the following management buttons; 1) discount rate, 2) purchase options, 3) subleases, 4) service contracts, and 5) renewal options. This stems from the fact that this information is in virtually all cases not needed for current lease accounting and/or is calculated using ‘rules of thumb’. Figure 6.5 summarises the management buttons that are considered to be most important to focus on when the CRE data management is addressed.

The other management buttons -the location, the rent, lease term, financing arrangement and the number of assets- are, thus, in virtually all situations known. It should be noted that gathering and analysing the information takes considerable time and effort, when not having all the required data available, considering the number of leases that have been entered into years ago at numerous decentralised locations. An interesting observation, thereby, is that the corporations that operated on the lower levels of the Joroff-model lacked more data entries and were often not aware of the upcoming changes while the CREM divisions that are operating on the ‘Strategist’ stage of the Joroff-model were in all cases aware of the IFRS lease accounting proposals and were equipped with centralised data systems. Once again, this does not imply that this holds for the AEX listed corporations that were not interviewed.

“The challenge is not to get ready on time but in keeping the system up to date and to ensure that the system is not contaminated after the implementation of the lease accounting proposals.”

Furthermore, all interviewees recognised the benefits of possessing a centralised data system and argued: “central management of the CRE will become a next option now that CRE gets more and more the attention of the board.” However, it was argued to be a challenge to keep the data (hence all ten management buttons) reliable and up to date in future years. Thereby, a large amount of time and effort will have to be invested in training CREM personal how to deal with these systems.
The observation that not all interviewed companies are aware of the proposed changes and/or did not possessed the necessary data, implies that these companies are not, or accompanied with the wrong numbers, in conversation with their financers concerning the possible breaching of their debt covenants. This was confirmed these interviewees and sounds rather worrisome when the implementation date, that is tentatively put on the first of January 2017, is rapidly approaching. Communicating the possible impact of the future lease accounting guidance to all the stakeholders is key in order to create awareness. However, another interviewee argued that:

“We are already in conversation with their financers concerning the possible impacts but that it is too early in the process (i.e. the final ED is not released) for discussing the (possible) impact(s) on the corporate KPIs and debt covenants. Furthermore, conversations with credit rating agencies are started but are still premature.”

6.2.4 Interview part 3: Transaction management

Chapter 4 argued that the proposed lease accounting changes can cause transaction processes to be more time consuming because the reassessment of changes in lease contracts can be a tug of war between, for example; lessees and lessors, and lessees and their financers. The used discount rate, break options and elements of a lease that can be viewed as separate components could have significant impact on the total amount of added liability. To reduce the effect of the proposed IFRS regulations (hence the capitalisation of operating leases), lessees may attempt to (re)negotiate the ten management button, as shown in figure 6.2. This implies that lessees will, in certain situations, structure leases so they would be recognised, e.g., for a shorter lease term and/or the effect of the lease capitalisation is smoothed. Therefore the most important questions were;

- “Are you tied to specific mandates to buy/lease real estate assets?”,
- “Does your CREM division take IFRS lease accounting into account with current real estate lease transactions?”,
- “Will IFRS lease accounting have impact on future transactions such as Sale & Leaseback transactions?”,
- “Do you actively strive for shorter lease terms due to IFRS lease accounting? If so, are you willing to pay a premium?”, and
- “Do you expect the negotiations between lessee and lessor to become more complicated?”.

The size – in general the financial size- of CRE transactions determines if the initiative has to be approved by the corporate board and, if approved, the calculations have to be verified after a certain period. Some CREM divisions even make an investment review a year after the completion of each project. The questions raised concerning the mandate accompanied with the responsibility regarding CRE transactions were, surprisingly, aligned according to their stage on the Joroff-model. This means that it holds for the interviewees that the CREM divisions operating on the ‘Strategist’ level had a large mandate and responsibility for making CRE decisions (i.e., to have the freedom to make decisions without approval of the corporate board). The amount for which decisions could be made without interference of the board gradually decreased when descending on the Joroff ladder, which is illustrated by the next three quotes of a ‘Strategist’ and a ‘Controller’;

“The CRE division has the mandate to execute real estate transactions and are, thus, responsible. All new to acquire locations or the ones that exceed the number of €500.000 will have to get approval by the board.”

“The mandate of CREM is very limited. Transactions above €15,000 need approval from secondary seniors and transactions above €500.000 need a signature of the CEO.”

“Regarding to the very limited CRE mandate the freedom to anticipate is very limited- the CREM department has a modest role within the organisation.”
A remarkable observation can be made out of the fact that big differences can be found between the CREM divisions that take the proposed IFRS lease accounting rules into account with current and past transaction negotiations and the CREM divisions that do not take the proposed rules into account with current transactions. Because these CREM divisions have, to date, no clear vision of the proposed changes, they cannot make statements about possible future difficulties with negotiating lease transactions. This is an important observation if one considers the fact that, for example, SLB transactions were entered to ‘clear’ the balance sheet of CRE as the next quote illustrates:

“Several office locations were sold and leased back in recent years to clear the corporate balance sheet with the goal to release capital to invest in the core business. However, as the proposed changes are getting clearer these Sale and Lease-back transactions may have an adverse effect on the corporate financial statements.”

These SLB transactions will, thus, once again be recognised on-balance. This shows that CRE decisions are being made by several interviewees without taking all the seven focus areas, as figure 3.5 discussed, into account. Other interviewees, however, made IFRS lease accounting part of the negotiation process whereby its importance is increasing. Especially with making calculations of large (SLB) transactions that continue after the effective date of IFRS lease accounting.

“For each transaction the impact on the borrowing capacity of the corporation is determined therefore IFRS lease accounting will be inevitably part of the decision making process, since it impacts various ratio’s related to this borrowing capacity. Therefore it could be a reason to structure leases having said that it does not affect the overall business strategy objectives.”

It can, thus, be stated that closing SLB contracts to clear the corporate balance sheets is no longer an option with future real estate transactions. This elimination of SLB transactions in order to obtain off-balance sheet accounting was supported by several interviewees and added with the fact that, in the end, ownership is cheaper than a SLB contract. However, when the transactions are strategically driven, do the interviewees not expect to change their decision-making processes. The same situation, as was seen with data management, appeared; CREM divisions that are not aware of the proposed changes to lease accounting do not take the proposed guidance into account with current real estate negotiations. Thereby, are these CREM divisions the ones that, due to IFRS lease accounting, will no longer close SLB contracts, because their decisions are not strategically driven. However, this does not mean that CREM divisions that are aware of the IFRS lease accounting project do take these proposed rules into account with current transactions as at least one of the interviewees argued that operated on the ‘Strategist’ level. This was again due to the fact that their strategy is leading and therefore their demand will not get altered by a changing accounting rule.

“We do not take the proposed lease accounting rules into account with current real estate transactions and we do not expect future transactions processes to become more complicated because of the fact that the corporate (real estate) strategy is leading and therefore their demand will not get altered by a changing accounting rule.”

This observation was also made when raising the question; “Do you actively strive for shorter lease terms due to IFRS lease accounting? If so, are you willing to pay a premium?”. The interviewees that operated on the ‘Strategist’ level stated situations may occur, with or without the proposed lease accounting guidance, that they are willing to pay a price in excess of the fair market price to obtain a specific CRE asset. But also CREM divisions that operate on the lower levels of the Joroff-model argued that the IFRS lease accounting proposals could strengthen their drive for short-term lease contracts and were, thus, willing to pay additional premiums to obtain these shorter lease contracts or by adding break options to the lease contracts. This implies that future negotiations between lessees and lessors will become more complicated. If the management buttons are taken into account, it is, as argued in chapter 2,
likely that because of the ‘grey’ area that provides the opportunity for structuring leases continues to exist, mainly due to the fact that CREM divisions are required to determine for themselves whether, for example, an ‘economic incentive’ exists to exercise a renewal option. This will make strategic establishment of renewal options an element that will be put it in a new perspective. Furthermore, several interviewees argued that the goal is to be able to remove or at least clearly distinguish the service component from the lease contract. This ensures that by distinguishing these elements the service payments do not have to be capitalised on the corporate balance sheet, making contracts more transparent. One interviewee indicated that they had developed in line with the proposed IFRS lease accounting rules a new standard for service contracts. Thereby, it is argued that the IRR implicit in the lease to capitalise the leases will rather not be used by lessees because this return is that low causing the impact to be sufficiently higher. Therefore, a specified WACC per asset is determined, if the lessor is not transparent in this data. Concerning lease incentives several interviewees argued that cash incentives are considered to be the most important incentives because of its larger positive impact on the corporate income statement than shorter lease terms. All interviewees emphasised the greater importance of the income statement compared with the corporate balance sheet, hence the following quote;

“(…)‘cash’ is considered to be more important than the balance sheet.”

This is an important observation if one considers that the largest impact of IFRS lease accounting, when discussing CRE, will concern the corporate balance sheet. It should thereby be noted that all interviewees stated that renegotiating current lease contracts entered under IAS 17 is not an option and that, thus, all proposed changes due to IFRS lease accounting will be made with future lease transactions. Hence the following quote:

“However, current lease contracts are mostly long-term contracts (twelve year lease terms are no exception) and renegotiation of these contracts is not an option.”

In contrast to Canon and Fenbert (2011), who found that: “Nearly all respondents we spoke with confirmed that the elimination of the operating lease classification would eliminate any creative lease structure to avoid the distinct line imposed by the current classification. (…) companies would be less restricted during lease negotiations when consideration for lease categorization is no longer a constraint.”, this thesis found that certain companies would be more inclined than others to modify their typical lease contracts in order to reduce the operating lease liability reported on their balance sheet. This refers to, as argued, making adjustments to the used discount rate, making premium payments to reduce the base, considering renewal options, distinguish service components from the lease contract, and dealing differently with incentives. This implies that, concerning transaction management, the highlighted management buttons in figure 6.6 are the ones to pay additional attention to with future negotiations.

Once more, the one on one link can be made clear that whenever CREM divisions operate at the ‘Strategist’ level of the Joroff-model that IFRS lease accounting will not change the outcome of the transaction management process. It can, thus, be argued that IFRS lease accounting may influence transaction management and thus will impact decision-making but probably not the actual decision to undertake the transaction. However, all interviewees argue that, depending on the nature of the asset, IFRS lease accounting may change some aspects of the lease agreements, thereby having a “less negative” effect on their financial statements. In these cases, companies would actively try to structure leases for the purpose
of achieving a particular accounting treatment. However, a company’s decision to structure a lease for accounting benefit would need to fit within the overall CRE strategy of the company without conflicting with another factor of greater relative importance.

6.2.5 Interview part 4: Portfolio decision-making

Many CREM divisions have not needed robust processes and controls for leases in the past because existing accounting models did not require leases to be periodically revisited. The proposal that leases should be re-measured will require CRE managers to redesign processes and controls to ensure proper management of all lease agreements. Initial recording on balance sheet and annual reassessment—for example contingent rent—of lease terms and payment estimates may require significant and complex changes of CRE managers to existing processes and internal controls, including support for significant management assumptions. Decision-making processes concerning portfolio strategy and portfolio management will, thus, be far more complex, especially when the corporate CREM division does not operate on the ‘Strategist’ stage of the Joroff-model and make use of (parts of) an Exchange use strategy. The survey showed that the CRE strategies often are a combination of other strategies and not just one of the Exchange use strategies. This implies that one cannot base the fact whether a corporation bears an impact of the proposed changes on their CRE strategy. It does, however, help to estimate if the impact will be large or small (e.g., does the CRE contain many financial aspects of the three exchange use strategies). Most pressing questions were therefore; “Will IFRS lease accounting have an effect on the CRE strategy?” and “Will IFRS lease accounting have an effect on portfolio decision-making?”.

None of the interviewees indicated they had intentions to change their CRE strategy due to the proposed IFRS lease accounting guidance. This is illustrated by the following quotes of a CREM division operating on the ‘Strategist’ level and the ‘Controller’ level;

“The CRE strategy is aimed at creating value. The CREM department has an ‘own’ strategy, which is directly derived from the business strategy and reports to the corporate CFO. The CRE decisions are, thus, always strategic in nature and driven by the corporate business strategy.”

The CREM divisions that did not operate on the ‘Strategist’ level of the Joroff-model did support the fact that the proposed rules could make them scrutinise their strategies to find out whether they are in line with the business strategy. This revision addresses all of the management buttons, with in particular the highlighted ones illustrated in figure 6.5, because information about these buttons was in many cases not known or only to a limited extent.

Changes to the CRE decision-making processes, however, could be one on one translated to the position of the CREM division on the Joroff-model. It was clearly argued by CREM divisions that operate at the ‘Strategist’ stage of the Joroff-model that they expect not to bear any impact concerning the decision-making process, indicated by the following quote.

“If IFRS lease accounting was definitely an issue in the mix of different components. The effects of IFRS lease accounting have been extensively examined and where part of the decision-making process, although resulting in a minimum impact. IFRS will in the end not be a game changer for the lease versus buy decision since the overall strategy is leading.”

The interviewed CREM divisions that are not operating on the ‘Strategist’ level of the Joroff-model were, in contrast to the CRE strategies, more open to change their CRE decision-making processes, as stated by one of the interviewees;

“The CREM division is changing and will anticipate on the proposed IFRS lease accounting regulations by steering on the smallest impact on the corporate financial statements, all within the boundaries of the CRE strategy.”

A typical management button that was referred to was the lease term. Several interviewees stated to have learned from the past and renounced ‘long’ lease terms because lease contracts with lease terms were common practice and are now dealing with vacancy rates. It
was added that when shorter term leases already provide a benefit (e.g., flexibility) given the current growth profiles of the CRE portfolio that the proposed changes to IFRS lease accounting magnifies their preference for shorter lease terms when it matches with their CRE strategy. It should, thereby, be noted that difference between lease terms in the E.U. and the U.S is also an important factor to take into account. Europe has, for example, in general shorter lease terms than the U.S., which implies that the same lease can be argued to be ‘short’ in the U.S. and can be seen as ‘long’ in the U.S.. One of the interviewees argued that their lease terms will not decrease in length, unless the impact of the proposed changes to the lease accounting guidance turns out to be significant. Other interviewees added that the impact on their decision-making will not be significant because their portfolio contains especially short-term leases and, thus, the impact on the corporations’ financial statements will not be significant.

Current CREM literature often describes the ‘lease vs. buy’ decision. In chapter 4 it is argued that this is short-sighted because there are many more options that need to be considered when acquiring CRE. However, partly due to the proposed IFRS lease accounting guidance will several financing arrangements (e.g., operational SLB contracts) disappear and new financing arrangements will be considered. A CTL was for example argued by two interviewees to get used more often. Revising the current list of corporate financing arrangements is thus a necessity and this was supported by the interviewees.

The management button ‘subleases’ was argued to be important because virtually all interviewees illustrated the situation that in some way different corporate business units lease space from the CREM division. Is this situation that is still desirable in the future when the proposed IFRS lease accounting is addressed? This question addresses individual specific situations that the interviewees would not commented on.

The rent is a key part of the operating expenses of CRE and, also, of the capitalisation process of the CRE assets. This simple fact made all interviewees state that clear choices have to be made about the rents that they are willing to pay and scrutinise situations when, for example, the rent incorporates lease incentives. The amount of rent that has to be paid can, when considering IFRS lease accounting, make CREM divisions choose for other financing arrangements. This, once more, highlights the link between the different management buttons.

The large difference between on the one side data management changes and transaction management changes, and on the other side portfolio decision-making changes is that the first two address ‘small’ changes that can be considered with every CRE asset. However, portfolio decision-making changes act due to the lease accounting proposals largely relate to the fact whether the assets are core (essential to the business), key (important but not critical), captive (low strategic value) or fluid (former high strategic value - now low) because for specific assets the financial impact is at all times subordinate to the strategic importance, as figure 6.7 (partly) repeats figure 4.8.

The position of core assets has a direct impact on the core business processes. Therefore, relatively long leases are used to secure strategic positions. For such strategic assets, IFRS

![Figure 6.7: CRE classification](source: Fitzpatrick (2010))
lease accounting and thereby the financial interest is subordinate to the strategic importance. Core assets are, for example, head offices or specific factories;

“The head office is currently the only CRE asset owned and will not be sold because the emotional impact outweighs the financial motives.”

“Current policy is to minimise the real estate exposure and to focus on the core business. The office portfolio is already 100% disclosed and is fully leased. Only specific factories and research centres are hard to finance in a lease construction because there is little to no lease market for such specific assets from investors perspective. These objects are that specific that a lease would be so high and commitments that long that ownership is often the only option.”

Fluid assets can, for example, be obtained due to an active position of the company on the acquisition market;

“The corporation is an active actor in the acquisition market and obtains many real estate assets because of these acquisitions. It is, however, not desirable to own CRE assets.”

These quotes show once more the link with the financing arrangement management button. Furthermore, one can argue that the location aspect of a fluid asset is far more negligible than in the case of a core asset. This was also supported by the interviewees, although was added that the location management button, when thus solely addressing tax regimes, will virtually never be decisive, but could be important in conjunction with other aspects (e.g., labour costs vs. tax when the CRE asset concerns a factory). The interviewees were not willing to address specific individual situations but a general statement could be made; The decisions about the lease term or financing arrangement of strategic real estate assets (e.g., highly specialised factories or retail locations) will not be altered and ‘fluid’ real estate assets (e.g., (back) offices) are the assets in the decision-making processes that could bear the most significant impact of the proposed changes to IFRS lease accounting, because of their low (strategic) importance.

For CREM divisions that, thus, do not operate on the ‘Strategist’ stage of the Joroff-model and the decision-making process does not concern a core or key asset, are the highlighted management buttons, illustrated by figure 6.8, the most important ones to alter the possible impacts of IFRS lease accounting, whereby the changes that have to be adapted are much more significant when corporations find themselves in a distressed capital position.

6.2.6 Interview part 5: In addition

This section discusses important additional remarks that were made by the interviewees outside the framework of the trichotomy data management, transaction management and portfolio decision-making. These remarks are mainly concentrated on the balancing between the perceived transparency versus the effort that CREM divisions have to put into the implementation of the lease accounting project and the perceived future position of the CREM divisions. The most important questions of this financial section of the interviews were; “What is your opinion about the changing IFRS rules?” and “Do you expect CREM to get more attention of the Board because of the balance sheet and income statement impact?”. The following four quotes address these questions:
“The gained transparency is seen as a positive feature. A downside could still be created with the ‘grey area’ of altering one of the ten operating decisions to influence the corporate KPIs. It is questionable whether this is desirable. Our opinion is that a changing accounting rule should not have any impact on future business decisions and the board does also not communicate worrisome indications concerning the new guidance. Furthermore, is it, in general, not expected that CREM reaches a board position due to the changes to IAS 17. The frequent contact with the board and in particular with the CFO is evident but this will level off over time if the consequences of the new guidance are clearly explained and visible. Thereby, it must be stated that the numerous delays cause a certain attitude of growing worriedness.”

“The vast majority of the AEX listed companies has currently no clue at all about IFRS lease accounting, let alone the impact. Especially these corporations will perceive great difficulty to manage the majority of data on-time. Balance technically leases will become less flexible and it will cause an additional tension between lease and lessor. It is interesting to execute IFRS benchmark studies whereupon different companies could be compared.”

“The changes to lease accounting will have significant impacts for most corporations either for financials this impact is limited. In addition we have other priorities than IFRS lease accounting. After the Enron scandal transparency is essential, however every stakeholder that follows this corporation on a professional basis can calculate the additional liabilities like Standard & Poor’s for example. Therefore, I have doubts about the usefulness of the additive amount of transparency that is created by the IFRS lease accounting standard. For non-financials with substantial more operating leases the impact will be much higher. But it should be noted that each self-respected AEX listed corporation should assess their CRE to their potential and should not underestimate the impact of the new IFRS lease accounting standard.”

“Currently the CRE Department reports to the COO. This is logical since the primary business process is highly dependent on the CRE. However, the CRE department prefers to report under the CFO because he might qualify CRE higher whereupon the mandate may be extended. The corporation currently works to improve its debt position. In relation to IFRS this would definitely impact future (CRE) lease decisions and perhaps new policies are introduced.”

These quotes make clear that not all the interviewees support the fact that IFRS lease accounting will create more transparency and the required effort is not in all cases desirable, e.g. when the corporation is transparent about their CRE and the financial statements are in good order. Furthermore, an interesting observation is the fact that all interviewees expect their daily practises to change somehow. It is, thereby, argued that IFRS lease accounting will act as a wake-up call for the corporate boards but most of the interviewees expect that CREM will (unfortunately) not last as an agenda issue of the corporate boards. Also the internal handling of IFRS lease accounting will become an important issue because several interviewees indicated that the position of the CREM division in the organisation will have its influence on the way the impact of IFRS lease accounting is dealt with.

6.3 Interviews with experts
In contrast to the interviews with the CRE managers the expert interviews where not held according to a specific structure. This was a deliberate choice since, more than with the CRE managers, the background differed from IFRS lease accounting to CRE strategy specialists. Figure 6.6 visualises the distribution of the interviewees over a CRE versus IFRS ruler. The experts gave additional and in-depth information about the complex interplay between those two elements. It is good to understand that the interviews were often highly specialised and in order to retain the readability, the interviews are distilled to the most interesting statements. Where the matter for the CRE was relative shallow, these interviews add a more profound layer to the context of the IFRS lease accounting implementation project. However, the topic IFRS lease accounting in relation to CRE is fairly unexplored and it is therefore hard for experts make statements about what the impact will be or what to expect.
As the crisis started to unfold, the criticism raised towards accounting regulation. Financials blamed accounting rules for the ‘flexible’ characteristics of the financial systems. This resulted in the collective need for more transparency and stricter guidelines. Cor Worms takes therefore one step back from solely IFRS and puts the topic in a broader context. IFRS lease regulations can be seen as one of the components to enhance transparency and financial creditworthiness within the total business sector. Implementation of Basel III for banks, Solvency II for insurance companies and upcoming the Solvency III edition concerning for pension funds are all examples of the expanding need for transparency. These regulations are all applicable to financial institutions, this is why financials should be seen apart from other CRE users. Eventually, accounting is to keep the capitalism honest and transparent. Universal and, above all, reliable data is essential for market-based economics. IFRSs are therefore vital and lease accounting regulations are part of this mission. Self-evident the introduction of IFRS lease accounting led to much commotion. Corporation executives’ salary is often linked to the corporate performance. Corporation boards have as a consequence- above average interest in accounting standards that allows them to present corporate performance in a more favourable way. Operational leases are a typical example of one of these elements. The introduction of IFRS lease accounting self-evidently resulted in powerful lobbying group -in particular in the U.S.- which transformed the implementation to a ‘game’ with high similarities to politics. A common used argument is- that the effort is not in relation with the potential transparency that is created, and that liabilities are already enclosed within the balance sheet disclosures. Both Brounen and Manschot argue that this is highly doubtful. Brounen stated as follows: “why are corporations than that afraid for transparency, when they are already transparent from their perspective? Probably they are not transparent at all- or even worse: they internal do not know what CRE lease liabilities they have”. The ‘transparent’ lease obligations in the disclosures are therefore not more than a well educated guess, data systems are out-dated, decentral organised or not even there. Thus, instead of writing comment letters they could better start with preparation of the implementation. The argument of corporations that the time span for implementing is too short is also highly doubtful.

The vast majority of the comment letters are traced back to corporations. Which is quite remarkable since the IFRS lease accounting changes in essence is introduced to provide the shareholder with more reliable and transparent data. Either currently there is a tendency from shareholders uniting in a lobby that is joining the IASBs and FASBs interests. Eumedion represents seventy of these institutional shareholders, and represented them in the IFRS lease accounting discussion. Eumedion can be seen as a ‘big fish’ within the pool of
associations representing seventy institutional investors with all together more than 1 trillion Euros of investments. Their comments are not gently towards the lobby of corporations. Eumedion fully supports the IASB in its mission to abolish the current artificial accounting standards that provide corporate executives to tweak balance sheet presentations in the favourable way for them. Operational leases are a serious amount of liabilities and are until today off-balance but they have a significant effect on leverage positions. It is according Martijn Bos a remarkable situation that shareholders have to invest in analysts that subsequently attempt to predict the "real financial situation" of a corporation; it is the opposite world. Corporations are complaining about the financial costs that go hand in hand with the implementation but they are not aware of the correction carrousel of analysts and auditors that are currently ‘running’ in order to correct their off-balance liabilities. Ultimately, it would not be more than logically that corporations pay for reliable and transparent financial reporting. Dingeman Manschot confirmed this statement and argues that the implementation costs, relating to data management, are negligible in relation towards other IT-systems. Besides, it should already be part of a corporation standard processes, otherwise you are not fully in control of your leases liabilities and more important the related risk exposure. Which contrarily could be a serious cost item is the renegotiation of all other contracts. With former accounting issues this was standard procedure but Manschot expects this will not be the case for IFRS lease accounting changes. Manschot substantiated his expectations by the fact that lease accounting significantly hits the leverage position, in addition he expect that banks will exploiting the situation to tighten their guidelines.

Eumedion argues in their comment letter that: “The IASB should have little sympathy for the lobby against IFRS lease accounting changes” and thinks the arguments of the lobby are rather dubious. Subsequently, Martijn Bos thinks the lobby is an initiative from a few corporations that have initial hesitation; the real lobby comes from the lease industry, since it abolishes on of the unique selling point of leases.

Notwithstanding, IFRS lease accounting is an accounting regulation that changes balance sheet presentations, however at the end there will be no changes in the ‘real world’. Dingeman Manschot would, for this reason, be surprised if the introduction will result in significant changes in (CRE) lease decisions. Only corporations, whose balance sheet is already under pressure, might attempt to reduce the effects as much as possible. Furthermore, it will depend from the position of CREM within the firm. If CRE is seen as a financial asset the possible consequences might be higher regarding the financial motives. Flip Verwaaijen argues that in essence CRE should be seen as a production asset, since it is facilitating the business process. Therefore CRE should, in the opinion of Verwaaijen, operate under guidance of the COO. Encompassing the side note that CRE is a capital intensive asset, which is, therefore, not limited to business processes strategies but also affects financial statement strategies. It is, subsequently, not surprising that CRE departments differ in reportage commitment from COO to CFO. In fact, CRE is in the middle of them, within the opinion of Verwaaijen a tendency to the COO. The implementation of IFRS lease accounting will increase the field of tension between these two different interests, since CRE decisions will impact the balance sheet more directly. This results in a tug of war between the COO and CFO, whereby the corporate political policy preference will be decisive. The CRE could be a mediator within this political process, it should form the bridge between the accounting and operational business world. Once again, it can be stated that the impact of IFRS lease accounting on CRE decisions is highly dependent from the political tension between COO and CFO. If the interest of the CFO dominates, in terms of balance sheet reporting, will this probably result in deviating decisions. Verwaaijen confirmed the possible impact on restructuring of service contracts55, and even stated this evolution seems to be inevitable. IFRS lease accounting will result in being a catalyst for the collective need to transparent lease rents and the incorporated service contracts.

Overall the experts agree that the new IFRS lease accounting guidance is a desired regulatory issue. The claimed existence of transparency according to operational leases in the disclosures is highly doubtful. The fact that rating agencies and credit suppliers already correct leases with multipliers indicates that this aspect is essential in financial reporting. However, none of the experts believes that an accounting rule should or could change corporations’ CRE.

50 Restructuring of the service contracts is one of the ten management buttons described in chapter 4.
strategy. Term of condition is; CRE decisions are made with a strategic driving force. This condition is according to Verwaaijen and Brounen often disputable. In practice CRE is too often used as fund for ‘a rainy day’ instead of strengthen the core business. However, four experts believe that CRE will rise on the corporate’s board agenda due the financial impact of the IFRS lease accounting guidance. If this attention will be temporarily or not is a remaining question, which is hard to answer. Inevitable is the obligation for corporations to manage their CRE related assets and liabilities. It was striking to notice that in particular the financial experts thought that this data management was already common practice for each corporation. In contrast to the more CRE orientated experts which emphasised in particular this data management towards CRE assets and liabilities could form a real headache issue for the greater part of the AEX listed corporations. These experts would, therefore, not be surprised if the IFRS lease accounting guidance will lead to additional CRE lease liabilities. This shed of light in the dark corner could form a wakeup call for corporates boards to professionalise their CREM.

More controversial is the expectation if the lease accounting regulation will be introduced or not and within which time span? Hans Hoogervorst obviously does not doubt the implementation, he only questions in what form? Dingeman Manschot and Dirk Brounen are more critical and do not think that an introduction is already a given fact. The strong lobby against the regulations plays an important part in their doubts. In addition, the convergence with the FASB is according to Manschot essential to the credibility of the standard-setting bodies (i.e., the IASB and FASB). A relative new actor in the lease accounting arena is the shareholder. The lobby of the, until now quiet, shareholders is increasing and supporting the IASB. This new force might form the crucial tipping point for the implementation of the lease accounting guidance.

6.4 What if? Two hypothetical cases

This section provides two business case examples to clarify the possible impacts on CREM decision-making, but more important how to deal with these new implications with the help of the provided ten management buttons. Two totally different business cases are provided; case I concerns the acquisition of non-strategic office space, where case II is about the acquisition of a specialised factory. These cases are hypothetical because assumptions had to be made to provide an insight concerning the impacts of the proposed accounting changes for CRE managers but, above all, the IFRS lease accounting project is still subject to changes.

**Case I**

Company X is currently acting on the ‘Controller’ stage. The company has a stressed financial position and the future of the corporation is uncertain. One of the main objectives of the board is to build in flexibility in their business units in order to anticipate on the uncertain future and the boards’ intention is to reduce the financial impact as much as possible to prevent the possible breaching of debt covenants.

Due to the introduction of IFRS lease accounting regulations all lease liabilities became visible. In addition, the company has a relatively high operational lease exposure (REL) ratio relating to their peers within the industry. The CREM department’s data management evolved in professionalism and gained full insight in todays and future space demands. Furthermore, the corporation possess several relative large office buildings that can be considered as fluid assets in ownership. Since the uncertain future perspective, the CREM department advises the board to acquire more flexibility into the CRE portfolio and considers the following adoptions of the management buttons:

The differences between the accounting treatments concerning ownership, SLBs, and leases are reduced because the possibility of off-balance sheet accounting for leases disappears. Company X has several options whereof retaining the asset in ownership, SLB transactions and lease are the most commonly used financing arrangements. Before the introduction of IFRS lease accounting company X had chosen for a SLB transaction, since the CREM department had the possibility to acquire a cash incentive from the sale and it cleared the balance sheet of CRE exposure. However, after the introduction of IFRS lease accounting the CREM division may choose to sell the office building and acquires a three year lease of office space in another building or outsource their office space needs. It concerns a fluid asset with low strategic value, therefore short-term lease contracts are applicable to fulfil the demand of more flexibility and it will thereby lead to a significant lower burden on the balance sheet liabilities.
The CREM division proposed two options: Option I: sign a long term lease contract of fifteen years with an annual lease of €10,000 per year and a furniture incentive and a cash incentive of €20,000. Option II: is a short lease term of three years with an annual lease payment of €12,500 per year and a cash incentive of €7,500. Before the introduction of IFRS lease accounting the board probably chose option I. Since the CREM department was operating on the ‘Controller’ stage and CRE decisions are hardly strategically driven, would the ‘quick cash’ of the cash option improve the financial position of the company on the short term and there was no impact on the balance sheet since the operational lease liability was financed off-balance. After the introduction of IFRS lease accounting the board will probably choose for option II because this option mitigates the effects on the balance sheet and reduces the impact on their KPIs, improves the performance towards their peers and, most important, option II foresees in the demand of more flexibility.

To have a positive impact on the financial position of the corporation, the CREM division could choose to sell all of their fluid assets and, thus, reduce their real estate portfolio significantly. The smaller amount of assets is advantageous for the balance sheet recognition and provides the opportunity to close very flexible short-term contracts with, for example, Regus to provide in their needs of office space.

Service contracts form a substantive element of the lease obligation. Nowadays incentives e.g. furniture and security are incorporated in the lease fee and are often not a service component in the lease. Company X would probably impose the lessor to split the lease contract in service components and the lease of the asset, since the IFRS guidelines are not applicable for service contracts. This might result in additional negotiations, besides negotiations with the lessor, with the service providers in order to close the best possible contracts. However, it results in more transparency in what is paid for what service.

Due to the introduction of IFRS lease accounting the discount rate becomes an important tool to minimise the IFRS lease accounting impact. Since corporation X has a stressed financial position their incremental WACC would probably be higher than the IRR of the lessor. A high discount rate reduces the NPV of the lease liability. The higher the discount rate the lower the impact. Corporation X will therefore prefer his own incremental discount rate Company X could therefore ask the lessor not to recognise the yield made on the asset in the lease contract in order to be able to capitalise their payments with their WACC instead of the IRR of the lessor, which, thus, reduces the lease liability.

The rent is a straightforward button to manage; the lower the rent the lower the impact on the balance sheet. Company X is used to accept incentives in return for a higher initial rent. However, under IFRS lease accounting regulations this would result in a significant higher impact. It will, thus, be essential to consider premiums on top of the rent to obtain shorter lease terms since the company has an uncertain future. Incorporated incentives will therefore be avoided. A balance should be found between the lease price and lease term.

The company used to prefer long lease terms that corresponded with the entered SLB contracts. The CREM division considers adding options to their lease contract since these long-term leases add a large amount of debt to the corporate balance sheet. IFRS lease accounting, however, stipulates to recognise all break and renewal options, with an economic incentive to be exercised, on the corporate balance sheet. It is therefore essential to scrutinise how these renewal options are structured since an economic incentive could result in additional liabilities. It is thus very important to, once again, find the right balance between the number of break/renewal options and the on-balance recognition of these break/renewal options.

The SLB transaction that company X considers would foresee in the need for cash. An unwanted side effect is the balance sheet impact. Company X eventually chooses for a SLB transaction but wants to reduce the negative impact on their KPIs. By eliminating the purchase option, incorporated in the SLB contract, the SLB transaction is classified under the SLE approach instead of the I&A approach. This results in a significant lower impact especially in the early stages of the lease contract. The described front-end loaded effect, illustrated in chapter 2 and 3, is averted and the exercise price of the purchase option does not have to be added to the lease payments.

Company X possesses several office buildings in different countries. The tax rate should be taken into account in order to minimise the balance sheet impact. Although the tax rate forms a very small part of the impact, it could be profitable to negotiate with the lessor who has the most profitable tax impact (and thus structure the lease according to these most profitable impacts). This is different for every country.

Before the introduction of IFRS lease accounting the board considered subleases of the relative large office asset. After the introduction of IFRS lease accounting CREM evolved and advised more flexibility. In addition, company X’s core business is not real estate, thus it should not participate in this market.
Company Y wants to expand with a new factory to ensure the future continuity of the corporation. This factory will be assembled to household two large pieces of specialised production machinery. The building has to be adapted for the highly sophisticated equipment and is therefore targeted as a core asset. Company Y will, thus, have to recognise three components: one property lease and two equipment leases. Furthermore, the CREM division operates on the ‘Dealmaker’ level and enjoys a sound financial position accompanied with a low WACC. This case concerns the real estate part of the lease. The CREM division could make the following decisions regarding to the ten management buttons:

This factory has to household two large pieces of equipment and is therefore highly specialised. Thereby, the factory will become a core or key asset. Since these specific characteristics of the asset it will be hard to find a lessor who wants to invest in these types of assets. The two remaining options are SLB (outright) ownership. Before the implementation of IFRS lease accounting, the balance sheet recognition of these elements would advantageous for a SLB transaction. After the introduction this off-balance sheet recognition disappears and virtually no advantage for a SLB transaction remains. This implies that in the future situation (outright) ownership is more advantageous for company Y.

The CREM division will retain the building for as long as possible in situations where the CREM division has opted for a lease contract because of the strategic essence of the asset. The strategic driver of long term stability will overrule the balance sheet impact. However, when the term of the asset will be highly dependent on the equipment installed in the factory. Is the machinery replaceable with the same equipment or are large adoptions to the building necessary to once again household this new equipment. This will co-determine the length of the lease contract.

This management button is not applicable in this case because it solely addresses a single asset. However, it could be argued that aiming for one centralised factory could be more favourable for the corporate balance sheet than several decentralised factories. Thus, a calculation should be made addressing these different scenarios.

Whether a corporation operates at the ‘Taskmaster’ stage or at the ‘Strategist’ stage, it is in every transaction wise to separate the service components as much as possible from the financing components of the lease. Hereby will the impact be mitigated and the transparency between all stakeholders will increase.

Due the introduction of IFRS lease accounting the discount rate becomes an important tool to minimise the IFRS lease accounting impact. The incremental WACC would probably be lower than the yield of the lessor for the factory since corporation Y has a sound financial position. A high(er) discount rate reduces the NPV of the lease liability. The higher the discount rate the lower the impact. Corporation Y will therefore prefer the discount rate of the lessor. Company Y will therefore ask the lessor to add the IRR to the lease contract in order to minimise the lease liability.

It can be argued that, compared with Case I, renewal or break options are not likely to make any difference in the case of a long term lease contract. The IFRS lease accounting proposals stipulate that all options that carry ‘an economic incentive to exercise’ are being recognised in the corporate financial statements. It will, probably, not be profitable for company Y to add break or renewal options to their lease contract since the asset that company Y would like to acquire concerns a specialised asset and will, thus, be expensive to incorporate options in the lease.

Accounting for purchase options is the same as accounting for options added to lease contract. This means that if company Y has an economic incentive to exercise the purchase option, would the price of the asset added to the lease contract. The CREM division may wonder if this option is even necessary because the real estate asset may become (partly) useless when the equipment is outdated and needs to get replaced. It is, thus, highly dependent on the machinery placed inside the factory (e.g., can it be replaced with the same equipment or not?) whether these options are useful to incorporate in the lease.

Company Y enters into a forty-year lease contract and agrees to pay the following annual payments at the end of the year to the lessor: £20,000 increased with the CPI. The initial measurement of the liability to make lease payments is £33,000 using a discount rate of 4%. The lease does consume a major portion of the asset’s economic life and the PV of the fixed lease payments does account for substantially all of the asset’s fair value; the lease will, thus, be recognised according to the I&B approach. To mitigate the balance sheet impact the CREM division could consider the structuring with options to obtain an SLE approach and consequently obtain a single line expense instead of a front-end loaded expense. One could however question what is more important in the case of this core asset; the length of the lease
or the accounting method. It is, however, argued that whenever a lease is constructed that appears to be constructed in the discussed ‘grey area’, it could be profitable for company Y to structure the lease with break/renewal and/or purchase options to obtain the SLE approach of recognition.

The factory is considered to be a core asset. The location of this core asset may however not be of the greatest importance since the factory can be located in many different countries in which company Y operates. It can therefore be favourable for company Y to take with making the location choice the tax rate of different countries into consideration. For example, the Netherlands apply a tax rate of 25.5% while Belgium applies a tax rate of 34% and Germany a tax rate of 40.4%. This can make a difference in calculating the corporate WACC.

Since the specific characteristics of the asset will sublease(s) not be desirable or even not possible.

As stated before, these cases are hypothetical and the required input depends on a large number of variables. These cases provide, however, a clear view of the variety of possibilities that CREM divisions have to adapt the provided management buttons to obtain different results after the implementation of the IFRS lease accounting guidance.

6.5 IFRS lease accounting implementation recommendations

There are many small and large changes that are stipulated by the proposed IFRS lease accounting regulations, as inter alia the cases in section 6.4 showed. How the transition of the new IFRS lease accounting will proceed will be documented by the IASB and the FASB in their final standard and compliance requirements. This section will, therefore, not discuss those aspects but summarises the key recommendations, according to the trichotomy, for CREM divisions to be able to cope with the proposed changes to lease accounting.

Data management
First of all the data regarding leases should be gathered (with the help of other business units). This concerns all data that the ten management buttons address. However, the most important advice is to document this data in a central data management system. This will prove to be a large advantage because of the continuous measurement that has to be conducted and the awareness it creates about the CRE portfolio. A continuous re-assessment and alignment with business units is, thus, essential.

Transaction management
IFRS lease accounting will indirectly change the negotiations with the lessors because of the on-balance recognition of, for example, incentives, service contracts, break options, renewal options and purchase options. These lease elements should thus be scrutinised by the CREM department in order to be able to make the right decisions with current and future negotiations with lessors and other stakeholders. It should, once again, be noted that current lease arrangements will have to be capitalised in the near future. A clear view on each of the management buttons is thus key is the transaction management process.

Portfolio decision-making
A commonly used financing arrangement, the operational SLB, will disappear and other financing arrangements, such as ownership will become more profitable in several situations because ownership will result in a different expense pattern as depreciation will be stretched out over the economic useful life, whereas amortisation of the leased asset is spread over a shorter term lease. The preferred financing arrangement should thus be revised. This also applies to the decisions that are made within the current CRE strategy. Are these decisions still in line with the CRE strategy after the implementation of the proposed IFRS lease accounting?

It can furthermore be argued that IFRS lease accounting may influence transaction management and thus will impact decision-making but in many cases, probably, not the
actual decision to undertake the transaction. The lease accounting project can, however, be a catalyst for the level and urgency of CRE on the agenda of the board because it affects the performance indicators significantly, ignorance is no option anymore. This will provide the CREM divisions in the near future an important position in the organisation, especially between the COO and CFO.

6.6 Conclusion

This thesis covers a technical topic with on the one hand IFRS lease accounting and the other hand CREM. That this thesis is making the first footsteps in new terrain was confirmed within the interviews and provided an additional challenge. The macro analysis provided a good framework during this expedition; it made a rather static topic more comprehensible for all the interviewees. Notwithstanding, there were just a handful CRE managers and experts that could connect the two elements and put them in perspective. The interviews tend to be sec. financial driven by IFRS or specific CRE focused, the middle was hard to find. Therefore, this could become a bottleneck for the implementation of the proposed IFRS lease accounting guidance if no timely reassessment is made. The interviews give, however, a unique peek into the ‘engine room’ of CRE departments, supplemented with the specific knowledge of experts.

Some of the interviewees where to a greater or lesser extend acquainted with the potential impact of IFRS lease accounting. It was striking to notice this where all corporations who act on the Strategist level of the Joroff-model. These corporations already made analysis for current transaction with and without lease accounting. However, until now lease accounting was in the mix of factors such as, location, long-term need and control, and market risk never a game changer. In addition, the interviewees who operate on the Strategist level are more aware of the possibilities to mitigate the effect due the management buttons discussed in chapter 4. But the primary strategy drivers are according these corporations overruling the financial statement impact of IFRS lease accounting. It should, thereby, be noticed that this consideration depends on each specific corporation and asset characteristics. Note the large difference between the ‘normal’ users of CRE and the financial institutions which are subject to additional regulations such as Basel III for banks and Solvency II for insurance companies.

Corporations who operate lower on the Joroff-model tend to be more inclined to be affected by IFRS lease accounting. This is because they are obligated to extend their data system which gives them more understanding about their occupancy, space demand and efficiency than before the introduction. This additional insight will potentially lead to a more profound link between CRE strategy and their corresponding operating decisions. Ultimately, decisions should result in utilisation of the underlying real estate that provides optimal support to the core business of the company. While a core set of factors drive CRE decisions for most companies, each company is likely to attribute relative importance across factors differently and, consequentially, also relative importance to the ten management buttons.

However, the structuring of PVs with renewal options and changes to calculating with incentives and service contracts is not made impossible by reinstating the bright-line tests, this is no longer an issue for the IASB who are focusing on the on-balance recognition of operational leases. Thereby, interesting conversations may be expected between the lessee and the accountant (since the lessees have to determine which renewal options should be marked as an economic incentive) and between the COO and CFO whereby the CREM department operates as the spider in the web. The proposed changes to IFRS lease accounting may, therefore, be seen as a catalyst to implementing change.
Conclusions & recommendations

The previous chapters provided theoretical and practical answers about the five sub-questions on IFRS lease accounting, CRE strategies and operating decisions in order to provide a well-founded solution for the research question; “What impact do lease accounting changes have on corporate real estate strategies, and what are the consequences for future corporate real estate operating decisions?”. The research question is answered in this section on the basis of a CREM literature review, a macro analysis of AEX publicly traded companies, and interviews with stakeholders in two segments; AEX publicly traded CRE users and IFRS/CRE professionals. This chapter captures the final conclusions for this thesis in order to answer the research question and the research objective in section §7.1. Furthermore, section §7.2 reflects this thesis and the corresponding process and recommendations for further research will be provided in section §7.3.

7.1 Conclusions

“The world as we have created it is a process of our thinking. It cannot be changed without changing our thinking.”

(Albert Einstein)

IFRS lease accounting, why?
Numerous financial scandals were the motivation for the observation of the IASB and FASB that leases should be considered as an important source of financing. As a result the IASB and FASB started with a project to develop a global financial reporting system in 2006, including reporting for leases, which would have to prevent these major ‘Enron-like’ scandals. Transparency to the users of financial statements is key in this project. The IASB and the FASB have, therefore, stipulated that the current difference between finance leases and operating leases will disappear and for all leases a ROU asset and a lease liability will have to be recognised in the corporate balance sheet, most likely from 2017 onwards. These changes to current lease accounting are mandatory for all users of IFRS. Past research showed that accounting is a potential variable in CRE decision-making, but no study before, as far it is known, neither distinguished between the possible impact of IFRS lease accounting on CRE strategies and the relating CRE operating decisions nor provided insight how to cope with these possible implications. This resulted in the goal of this thesis to answer the following research question:

What impact do lease accounting changes have on corporate real estate strategies, and what are the consequences for future corporate real estate operating decisions?

The possible damage
The changes to accounting guidance will change the way in which corporations communicate about their CRE management. The proposed guidance stipulates that the corporate CREM divisions report transparently and on a structural basis about their CRE portfolio. The information regarding a company’s real estate use and costs will become much more transparent and will appear continuously in all financial statements. The macro analysis concluded that the relative amount of property & land in relation to the total assets of AEX listed corporations is significantly lower (7%) than the findings of previous studies. This is remarkable since several previous studies emphasised the relative large amount of CRE on corporate balance sheets, varying from 15% to 20%. However, it is shown that the IFRS lease accounting project still causes a combined amount of approximately €15 billion of off-balance CRE operational lease obligations to be added to the AEX listed corporate balance sheets. One
would guess that possible impacts to these amounts of obligations are under the full attention of the CREM divisions of the AEX publicly traded corporations, but this is not the case. The awareness of the lease accounting project varied from CREM divisions that are fully aware of the upcoming changes and keep track of the deliberations to CREM divisions that were not aware of the IFRS convergence project or even to corporations that lack a CREM department.

**CRE strategies**

This study argues that a CREM division adds most value to the business when the CRE strategy is derived from the business strategy. The Joroff-model showed that solely CREM divisions that operate at the ‘Strategist’ stage of the Joroff-model meet this assumption of a derived CRE strategy. It is, thereby, argued that CREM divisions that are operating on the ‘Strategist’ level will bear no impact concerning their CRE strategy because at this ‘Strategist’ stage CRE strategies are always driven by the corporate business strategy. This was supported with the data provided by CREM divisions operating on the ‘Strategist’ stage. This implies, thus, that when a CREM division does not operate on the ‘Strategist’ level it may experience a possible impact of the IFRS lease accounting proposals. Literature showed that of these CREM divisions the ones that rely on Exchange use strategies are most likely to bear an impact because these strategies rely heavily on financial components, i.e.;

- Reducing costs,
- Maximising flexibility, and,
- Increasing the value of the asset.

When a CREM division is not operating on the ‘Strategist’ stage, whether voluntary or not, the proposed IFRS lease accounting rules may be an impetus to revise their CRE strategy. It can, thus, be expected that the proposed IFRS lease accounting guidance will offer the CREM divisions the possibility to benchmark their business unit among others in the same sector and tempt CREM divisions to align their CRE strategy with the business strategy and thus move along the Joroff-model. This revision of the CRE strategy would be stimulated by the fact that IFRS lease accounting could be an eye opener for CREM divisions once they have all their CRE data available. The survey and several interviews indicated that it is, however, often the case that CREM divisions apply parts, combinations, or use multiple of these strategies and are, thus, not corresponding one on one with these exchange use strategies. Furthermore, all interviewees indicated that the calculated impact of IFRS lease accounting on the corporate KPIs is probably not large enough to act as a catalyst for changing their CRE strategy.

In general, thus, it can be stated that the gained transparency due to the proposed changes can be a catalyst for CREM divisions, operating on lower levels of the Joroff-model, to revise their CRE strategy and improve the alignment with the business strategy rather than change it as a response to the possible impact of the proposed changes.

“The proposed IFRS lease accounting guidance will act as an impetus for CREM divisions that do not act on the ‘Strategist’ stage of the Joroff-model to align their CRE strategy with the business strategy.”

**CRE operating decisions**

What about operating decisions? The tentative decisions made by the IASB and FASB prescribe that current and future CRE leases have to be recognised, virtually all according to the SLE approach, on-balance. This study argued that when CREM divisions are lacking an explicit CRE strategy that is consistent with the business strategy than they may exercise operating decisions that are unrelated to or even in conflict with the corporate business strategy rather than being consistent with their real estate strategy. This situation could cause organisations that rely heavily on financial components and own large CRE portfolios to make changes to their data management, transaction management and/or portfolio decisions, all with respect to CRE. Figure 7.1 illustrates the amount of millions of Euros that are related to each stage of the Joroff-model.
This implies that €5 billion of the approximately €15 billion of CRE value that will be recognised on-balance has the potential to bear a possible impact due to the proposed lease accounting changes.

“Lessees may change their decision-making processes due to the proposed IFRS lease accounting guidance.”

CREM divisions that are not aware of the upcoming changes in data provisions and lease contracts will have an immense number e.g., in the range of hundreds of lease contracts to trace in order to retrieve the required data. All interviewees supported the view that new IT systems to manage their data will be a necessity. The organisations that lack centralised CRE data management indicated that IFRS lease accounting could act as a catalyst to acquire centralised data management since IFRS lease accounting requires ‘continuous’ measurement of the total lease portfolio. Composing the data system is one thing, however, the challenging and most time consuming part is keeping the data system up to date and preclude the system from contamination. Furthermore, the corporate financial statements will be scrutinised by both internal as external auditors. This will, most likely, result in new, unknown, additional leases, in particular for corporations with no or a decentralised data systems. This new information will probably result in a larger impact, in terms of transparency, than the capitalisation of the current, already transparent, lease liabilities. Subsequently, this additional impact could cause compliances with debt covenants. Especially for corporations that are already charged with enhanced surveillances this could cause significant compliance issues.

“A large part of AEX listed companies have many lease contracts to trace and to process in order to get their data management on track.”

Changes to transaction management are considered possible for all respondents acting on the lower levels of the Joroff-model. This statement combined with the fact that the possible future impacts of IFRS lease accounting in a moderate way where taken into account during current transactions is remarkable. This can be attributed to the fact that some of the interviewed CREM divisions were unaware of the proposed lease accounting changes, but above all, that the respondents were waiting for the final exposure draft to take the IFRS lease accounting into account. One could, thus, experience the situation that a transaction was enacted while taking the proposed changes into account the transaction would not be made in that particular form (e.g., a long lease-term transaction). Notwithstanding some interviewees on ‘Strategist’ level already made extensive analyses for current transactions-with and without IFRS regulatory issues. But, up till now, the potential IFRS impact did not
seem to be a game changer within the mix of different components e.g. (flexibility, cash incentives, service contracts). Furthermore, the negotiations about future lease transactions with the lessor could change because lessees mention the desire to explore the possibilities of distilling service contracts out of the lease contract, the most favourable discount rate in the contract (one can ‘choose’ between the corporate WACC and the yield, IRR, as specified by the lessor) and the possibilities to lower the base rent (in combination with a higher contingent rent), all adding risk to the business of the lessor. It can thereby be assumed that these changes to transaction management will most likely occur with ‘fluid’ CRE assets. However, as all interviewees argued, changes to transaction management will depend on the context of each transaction and, therefore, are general changes hard to specify.

Portfolio decisions will endure the most significant impact. However, also with portfolio decisions, the place of the CREM division in the Joroff-model is of the utmost importance. It should, again, be emphasised; if a CREM division operates at the ‘Strategist’ level of the Joroff-model, one will bear no impact. Changes, for CREM divisions operating at the lower levels of the Joroff-model that were frequently mentioned are; reduce the lease term, remove the service contracts out of the lease contract, change the number of renewal options and, in some cases, change the financing arrangement (from a SLB contract to outright ownership). Shorter lease terms is the most pronounced effect, but in general shorter lease terms come with additional premiums on the rent. All interviewees mentioned that in most cases the cash incentives, which directly has positive impact on the income statement, in general overrules the impact of IFRS lease accounting (increase in balance sheet liabilities). As stated by one of the interviewees ‘cash is king’ which stresses the relation between balance sheet and income statement from a corporate perspective. Therefore a collective demand for shorter lease terms seems to be masquerade. Once more, these changes are most likely to expect for ‘fluid’ assets that are of no strategic importance to the corporation. But again changes are subsidiary to the specific situation and changes will differ for each lease transaction.

**How CREM divisions could deal with IFRS lease accounting**

Previous studies showed that the impact of IFRS lease accounting greatly differs among the sectors in which the company operates. This is evident because, for example, the retail sector relies heavily on real estate, while the industrial sector relies on their CRE far less. If one, subsequently, considers the fact that KPIs are most likely altered to align again with the sector-average, is not so important to know which sector bears the most impact but which companies within these sectors deviate from their (international) peers. Therefore, the REL-ratio is introduced to benchmark a CREM’s CRE lease portfolio within a sector. Once the relative impact is determined the CREM division can manage their CRE with the provided ten management buttons and ‘control’ the possible IFRS lease accounting impact. These ten management buttons, in a random order, are;

1. Rent,
2. Location,
3. Number of assets,
4. Lease term,
5. Financing arrangement,
6. Purchase option,
7. Renewal options,
8. Discount rate,
9. Service contracts, and,
10. Subleases.

Does all CRE have the same potential to be managed with these buttons? The answer is ‘no’. This potential largely relates to the fact whether the assets are core (essential to the business), key (important but not critical), captive (low strategic value) or fluid (former high strategic value - now low). This study argues that the ‘Fluid’ assets have, thus, the largest potential to be managed with the provided ten management buttons. The interviewees often related these ‘Fluid’ assets to decentralised office space.
Corporate governance

During the interviews the internal governance proved to be an important topic. First of all the fact should be considered that CREM divisions report to various board members; from the COO to the CFO. This implies that CREM divisions are settled on different targets and as a consequence will, thus, have to respond differently to possible IFRS lease accounting impacts. Furthermore, not only the internal control within the business unit will change, also the external management with the CFO and the accountant is required. Most of the interviewees supported the view that more frequent deliberations with the corporate CFO and accountant are a necessity because all leases have a direct impact on the corporate financial statements and, as some respondents indicated, could negatively alter debt covenants with banks. A good understanding of the available CREM resources is, thus, a critical ingredient for a successful implementation of the proposed changes. Such knowledge could create confidence among business units who are then more willing to cooperate and depend upon the CREM division to make value-adding decisions. It also ensures that CREM can communicate its contribution to the company in a language that the top decision makers understand. This ‘language’ will get far more important when, as argued, the relationship between the CRE executive and the corporate board (impersonated by the CFO?) will change due to the proposed IFRS lease accounting rules. This changing relationship does depend on the relative size of the CRE portfolio compared to the rest of the corporate assets as the interviewees expected. This implies that the €15 billion of CRE that has to be recognised on-balance will act as an eye-opener for the corporate board. Large CRE portfolios will have a larger impact than small CRE portfolios and, thus, benefit from a different significance on the agenda of the corporate board.

“CRE managers will become the spider in the web between the COO and CFO.”

The initial intentions versus the possible effects

Will the IASB and FASB accomplish what they want to achieve? They argued that the current accounting models have been criticised for failing to meet the needs of users of financial statements because they do not provide a faithful representation of leasing transactions (hence the accounting scandals). In particular they omit relevant information about rights and obligations that meet the definitions of assets and liabilities. The models also lead to a lack of comparability and undue complexity because of the sharp ‘bright-line’ distinction between finance leases and operating leases. It can be argued that the concerns about the transparency of corporations’ lease obligations and the desired comparability are met. But, owned CRE assets are recognised at book value while leased CRE assets are recognised at market value. Application and implementation of the new lease accounting rules are, as it has become clear, a major challenge. It was expected that the new leasing standard would lead to a reduction of complexity and that the current situation would be replaced by only one accounting model. Although the final standard is not released yet, it can be argued that, despite the obtained transparency, it is questionable if the dual model would ultimately simplify current lease accounting. Depending on the lease classification, some leases would be presented as an SLE expense in the income statement while others would be presented separately as an I&A expense. In addition, the bright-line test would provide a new opportunity to structure leases because corporate specific judgement still plays a large role for leases that fall in a ‘grey area’ (hence the future bright-line test). A lessee, for example, may be able to account for its leases of similar underlying assets (e.g., two real estate assets) under both the SLE and the I&A approach. Therefore, managers could continue with searching for lease contract terms (e.g., contingent rents, lease incentives and renewal options) that minimise the balance sheet impact of the proposed lease capitalisation. However, IFRS lease accounting is, in the end, an improvement for all stakeholders. The guidance may act as a catalyst for some corporations to revise their strategy and the impact of CREM on the corporate financial statements could act as an eye-opener for the corporate board. This improvement in professionalism will be a positive effect for shareholders. Thereby, users of financial statements do no longer have to rely on estimates based on rules of thumb and information presented in footnotes of financial statements to assess the impact of (CRE) leases on KPIs.
**Concluding**

In general, it can be concluded that the impact for a particular company would be largely based on three main factors: 1) the place of the company on the Joroff-model, 2) a company’s sensitivity, due to their CRE strategy, to financial statement presentation, and 3) the size of a company’s operating lease portfolio relative to its balance sheet. These factors make publicly traded companies more likely to change their behaviour to mitigate the effects of the proposed changes. As a result, CRE will attract more attention and new questions about their CRE use and their CRE strategy will be regarded by the stakeholders. Logically, but far from common practice for CREM divisions, it is first of all to understand what CRE related assets and liabilities they possess and why they have them according to the proposed REL benchmark. Providing transparency in an early stage with all stakeholders is crucial. Second, they should predict and model what the potential impact could be. Finally, corporations are able to prepare for the transition and mitigate the impact with the ten management buttons that are provided. This process is illustrated in figure 7.2.

![Figure 7.2: Management support tool](image)

It has been demonstrated that changing regulatory issues are not just compliance issues for all organisations but can be a catalyst for corporations to change their decision-making processes by altering, within the framework of the lease contract, the provided ten management buttons, possibly from 2017 onwards. This will concern the fluid assets, that are part of the approximately €5 billion of CRE lease obligations that are managed without a strong strategic incentive, because they are not of strategic relevance for the business. Thereby, CREM divisions of companies that work with IFRS will experience an on-going
increase in professionalism because the lease accounting project acts as a catalyst for CREM divisions, operating on lower levels of the Joroff-model, to revise their CRE strategy and align it with the business strategy. CRE managers have, thus, more than ever the potential to shape future successes for organisations.

“CRE managers will have an increased potential to shape future successes for organisations.”

7.2 Reflection
A first remark must be placed with the fact that the IFRS lease accounting rules are part of a larger set of regulatory issues that are part of a tendency to gain more transparency in financial statements and credit worthiness in the widest sense of term. It should therefore be seen within the wider spectrum which also encompasses, for example, Basel III and Solvency II. Second, the convergence to a worldwide lease accounting standard under IFRS may be called a remarkable project because of the duration of the project (since 2006) and the large scale fuss (hence the 800 comment letters in reply to the first ED and the fact that a RED will be released). Furthermore it should be noted that the changes to lease accounting are still tentative and under continuous deliberations by the IASB and FASB to date. These tentative decisions could, thus, be substantially modified before the final standard will be released. Notwithstanding this fuss and the continues postponement of the implementation of the new leasing standard, all the experts involved in this study are convinced of the fact that the only question raised should be ‘when’ instead of ‘if’ the operating leases are recognised on-balance. It was, thereby, surprising to note the large variety of awareness of the IFRS lease accounting proposals between the interviewed companies. The awareness varied from CREM divisions that are fully aware of the upcoming changes and keep track of the deliberations to CREM divisions that were not aware of the IFRS convergence project or even to corporations that lack a CREM department.

As all interviewees, argued, changes to transaction management will depend on the context of each transaction and, therefore, general changes are hard to specify. Corporations where not willing to profound in individual cases. In total eight AEX listed corporations, with a CREM division, were interviewed. Statements should therefore be seen within the context per sector, knowing that they are not representative for all corporations within this sector. An extensive study on sector specific impact is therefore expedient to make practical conclusions of IFRS regulations consequences. In addition, various experts expressed their vision. This resulted in a restricted sample, as for the corporations the experts are not representative for an entire sector/profession. Furthermore, one has to notice the influence of the current economic situation on the AEX publicly traded corporations. Companies that are bearing difficult times because of the current economic crisis are more prone to adapt their overall decision-making. This could imply that when this economic crisis is over, the susceptibility for changing decision-making processes could be largely reduced.

The added value of this research is the distinction that is made between the possible impact on CRE strategies and the possible impact on CRE operating decisions. It calculated the actual impact on the 23 AEX listed corporations, provided the REL ratio to benchmark CRE holdings, and, most important, the practical tools for CRE managers to cope with the changes.

Finally, it can be stated that it was remarkable to notice that CREM could become an important business unit in the eyes of all interviewees. If this will last is another question, but at least in the coming years, when the proposed IFRS guidance will be implemented, will CREM divisions become a very important business unit in the organisation.

7.3 Recommendations
This section will provide recommendations for further research on all parts of this research.

First, as it is discussed throughout this thesis, the proposed changes to lease accounting have not yet been finalised. Although this posed a challenge in our research, it was known when the study was initiated that it would be about analysing potential behavioural changes from a pre-implementation standpoint in order to provide the industry with a framework of the potential effects of these changes. If the standards are finalised and
implemented, there would be an opportunity to build on the subject research from a post-implementation standpoint once companies have had time to adjust their behaviour. Once the changes are implemented, research could follow to assess whether or not these potential changes actually occurred and to what degree. These research findings can act as a catalyst for others to take a more in-depth look at the identified relationships. Whether through the analysis of larger samples to challenge and/or validate these findings, or by a deeper examination of specific CRE practices, to better understand their relationship to corporate success and what needs to be done, to maximise the beneficial interaction. The results of such work can only benefit a discipline that is currently under-researched and critically lacking in the credible evidence it needs to prove its worth in the company’s production value-chain. Furthermore, global data about the CRE holdings can, after the introduction, be provided to support the REL ratio and the ten buttons can be ‘tested’; a so called longitudinal study.

Second, another challenge lies in studying other sectors or countries; such as the non-listed SME sector with companies that are also making use of the IFRS accounting guidance or (non-)listed companies in or outside the EU. IFRS lease accounting is applicable to all companies that use the IFRS guidance, however the impact on these companies could be different to the impact on AEX listed corporations.

Third, the impact on other stakeholders in the real estate sector is of significant importance. The most important stakeholders that should be taken into account are the lessors. The biggest change the lessors will see is probably a higher demand for shorter leases that will add risk to their business. Are they accepting the shift to increasingly shorter lease-terms? And, if so, will they require additional premiums to compensate the additional risk of shorter lease-terms? This could cause interesting negotiations concerning real estate transactions. Furthermore, it could be interesting to scrutinise the role of the financers regarding new possible forms of financing CRE (e.g., CTL).

Fourth, is the impact of IFRS lease accounting different in the situation when the CREM division operates under the CFO or, for example, the CHRM? Different business units have different internal control factors. This could imply that changing the board member to whom the CRE manager must report, could mean a different approach for CRE decision-making.
Bibliography


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