

FASB 13: “How the proposed changes will impact your leased portfolio strategy and the company’s balance sheet”

**November 3, 2010 (Charlotte, NC)
November 4, 2010 (Raleigh, NC)**

Agenda (Nov. 3rd-Charlotte)

12:00 – 12:10 pm ~ Welcome and Remarks ~ Hunter Fleshood, President Carolinas Chapter

12:10 – 1:10 pm ~ Roundtable Panel Discussion:
Moderator-William Parker, Real Estate Operations Prime, US East-Nortel
Mary Beth Kuzmanovich, VP Real Estate-Carolinas HealthCare System
Mike Schmitt, CPA Financial Analyst-Cassidy Turley
Patrick L. Ridinger, Partner-K&L Gates
Blair D. Bryan, Managing Director, Jones Lang LaSalle

1:10 – 1:45 pm ~ Q&A

1:45 – 2:00 pm ~ Facility Tour (CBI)

Agenda (Nov. 4th-Raleigh)

12:00 – 12:10 pm ~ Welcome and Remarks ~ Craig Youst, Vice President-Carolinas Chapter

12:10 – 1:10 pm ~ Roundtable Panel Discussion:
Moderator-William Parker, Real Estate Operations Prime, US East-Nortel
J. Michael Wilson, Partner-McGuireWoods LLP
Mike Schmitt, CPA Financial Analyst-Cassidy Turley
Hank Tremaine, Director-Deloitte Financial Advisory Services, LLP
Blair D. Bryan, Managing Director, Jones Lang LaSalle

1:10 – 1:45 pm ~ Q&A

1:45 – 2:00 pm ~ Facility Tour (STORR Office Environments)

Thank You

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- ❖ Today's sponsors

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Venue Sponsor-Nov 4th



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❖ **Rolling off end of year. Thank You for your Service!**

- Sandra Bobbitt, *Herman Miller*

Overview of Topics

- **Who are the players?**
- **Current U.S. lease accounting rules**
- **Why the push for change?**
- **Timeline for changes**
- **What will new rules look like?**
- **Financial statement impact**
- **How will end-users/clients be impacted?**
- **What can I do in the interim to minimize the impact?**

Who are the Players?

- **FASB** (Financial Accounting Standard Board)
 - 5 member group formed in 1973 to establish U.S. accounting & reporting policies referred to as “GAAP” (Generally Accepted Accounting Principles)
- **SEC** (Securities & Exchange Commission)
 - Government agency responsible for accounting & reporting standards for US publicly traded companies...SEC’s policy has been to rely on the private sector FASB for those standards
- **IASB** (Int’l Accounting Standards Board)
 - 15 member group responsible for establishing “IFRS” (International Financial Reporting Standards) permitted or required by over 100 countries around the world

Current U.S. Lease Accounting

- Statement of Financial Accounting Standard No. 13 (“FAS 13”)
 - basis of lease accounting rules since 1977
- FAS 13 General Principle:
 - A lease that transfers substantially all the benefits and risks of ownership should be accounted for as such
- For **Lessees**, there are only two types of leases:
 - ❖ **Capital Lease**
 - asset & liability booked by lessee if:
 - Ownership transferred to lessee @ end of lease term
 - Lessee has a bargain purchase option in the lease
 - Lease term is $\geq 75\%$ of estimated useful life of property
 - Present Value of rents $\geq 90\%$ of fair value of property
 - ❖ **Operating Lease**
 - all other leases are treated as an operating lease (lease payments are expensed as paid and no asset or liability is recorded)

Current U.S. Lease Accounting

❖ Additional rules for Operating Leases:

- Lessee “straight-lines” total rent over lease term:
 - Scheduled rent increases are included (OPEX are not)
 - Lease term includes all free rent periods
 - Lease term also includes renewal periods in cases where lessee determines at lease inception that renewal is “reasonably assured”
- Operating lease commitments for succeeding 5 years is required disclosure in the financial statement footnotes

Why the Push for Change?

❖ FAS 13 has long been debated because:

- The lease accounting rules are **complex** and open to wide interpretation...
- FASB & IASB are currently working on “**converging**” U.S. and international accounting standards...
- SEC wants to **eliminate** “off-balance sheet” **financing** arrangements
- Lessees are currently permitted to avoid booking a liability for most lease transactions, even though they typically incur a significant **financial obligation**...for example:
 - **Walgreens**
 - **US Air**
 - **UAL**



Timetable



New U.S. GAAP standard for fair value accounting for investment property to be released concurrently in mid-2011, similar to IAS 40

What Will New Rules Look Like?

- **Broad objective:**
 - Accounting should reflect “ownership” of the leased asset (& also obligations)
- **No more operating leases:**
 - “Right-of-use” asset and “obligation to pay” liability recorded on balance sheet at “cost” (= PV of payments over lease term)
 - Lease payments include all projected increases (fixed, CPI or %)
 - Amortization and interest expense replace rent expense
 - Includes subleases
- **Transition requirements:**
 - Recording assets and liabilities will be required for all leases outstanding on the transition date (except those with remaining term < 12 months)
 - Measurement will be the PV of remaining lease payments using lessee’s incremental borrowing rate as of transition date

What Will New Rules Look Like?

- **Lease term more likely to include renewals**
 - Lease term defined as longest possible term “more likely than not” to occur
 - Renewal terms with rates at or below “market” at the date of renewal will be required to be included in the initial lease term
- **Subsequent adjustments may be required**
 - “Change in facts and circumstances”
 - Original discount rate is used for entire lease term
- **Sale/Leaseback transactions**
 - Treated as a sale and subsequent lease ONLY if risks & benefits of ownership actually transfer to purchaser/lessor...if not, the lease is ignored and the transaction is treated as a loan

The Exposure Draft

The New Lease Model (the What)

- Eliminates all “operating leases” and requires them to be capitalized on a company’s balance sheet.
- Rent expense disappears from the P&L and is replaced with amortization and interest expense.
- No “grandfathering” of leases on effective date.

Impact on Financial Statements	
Balance Sheet	<ul style="list-style-type: none"> • Right-of-use asset • Obligation to make lease payments
P&L	<ul style="list-style-type: none"> • Amortization of right-of-use asset • Interest expense

Impact and Implications

Key Statistics:

- \$1.3 Trillion (est) to be added to corporate balance sheets in US.
- 70% of the lease value to be capitalized involves commercial real estate

Biggest impact on industries with large lease portfolios

- Retail and Banking (branch networks)

Estimated additions to balance sheets¹:

- Walgreens - \$35 billion
- CVS - \$27 billion
- Wal-Mart - \$13 billion
- McDonalds - \$ 10 billion
- Kroger - \$7 billion

¹ Figures supplied by Tririga, Inc. based on analysis of publicly available company 10-k reports.

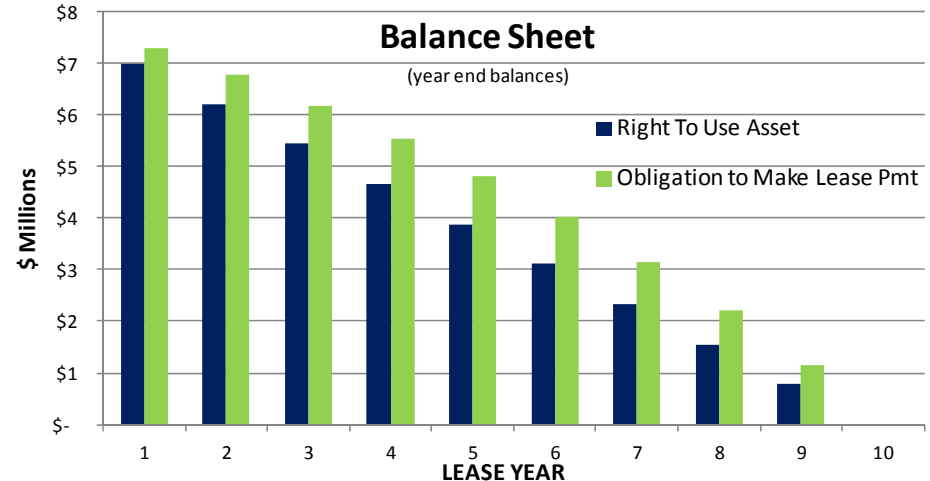
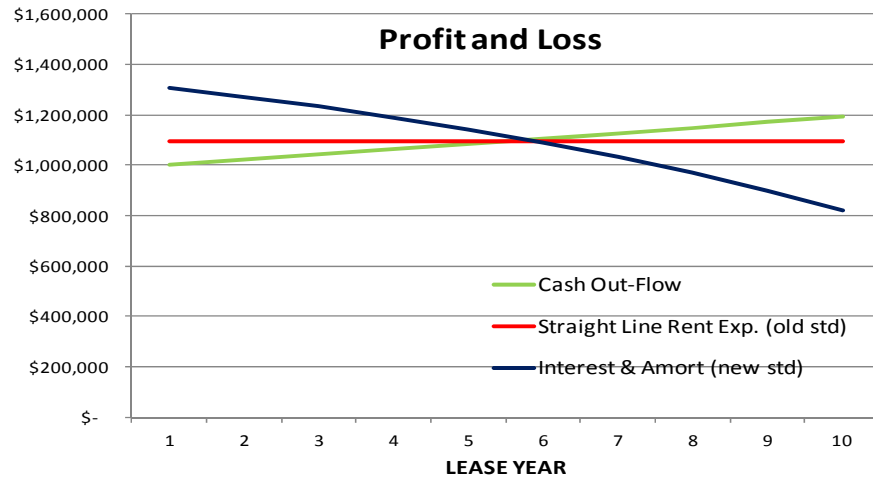
P&L Balance Sheet Impact

Lease Assumptions:

\$1,000,000 initial annual rent

2% annual escalation

7% Lessee incremental borrowing rate



Financial Statement Impact

- **Occupancy expense** will be “front-ended”
- **Equity** will be negatively affected during 1st half of lease term
- **Liabilities** will increase significantly
- **EBIDTA** will increase
- **Disclosure** requirements will likely be expanded

Financial Statement Impact

- **EBITDA will increase, possibly affecting:**
 - Company valuations (??)
 - Compensation or performance bonus models
 - Shareholder agreements
 - Will EBITDAR replace EBITDA?

- **Debt ratios will increase, possibly affecting:**
 - Existing loan covenants
 - Future borrowing capacity

Financial Statement Impact

- **Administrative costs will increase due to:**
 - Requirement to calculate PV lease cost for all outstanding leases at initial transition
 - Requirement to subsequently re-calculate PV lease payments and lease terms if facts change
 - Financial statement audits will require more testing of lease transactions
 - Companies will need to invest in new computer systems, processes and controls to monitor lease transactions

How Will Clients be Impacted?

❖ Future real estate decisions will be affected:

■ Lease or buy?

- Since the accounting will be similar, clients with cash may opt to purchase real estate vs lease...or will they?

■ Demand for shorter lease terms?

- Effort to minimize lessee's financial statement impact
- Will shorter term mean higher lease rates?
- Shorter lease terms will likely reduce the appraised value of building – will landlords agree?

How Will Clients be Impacted?

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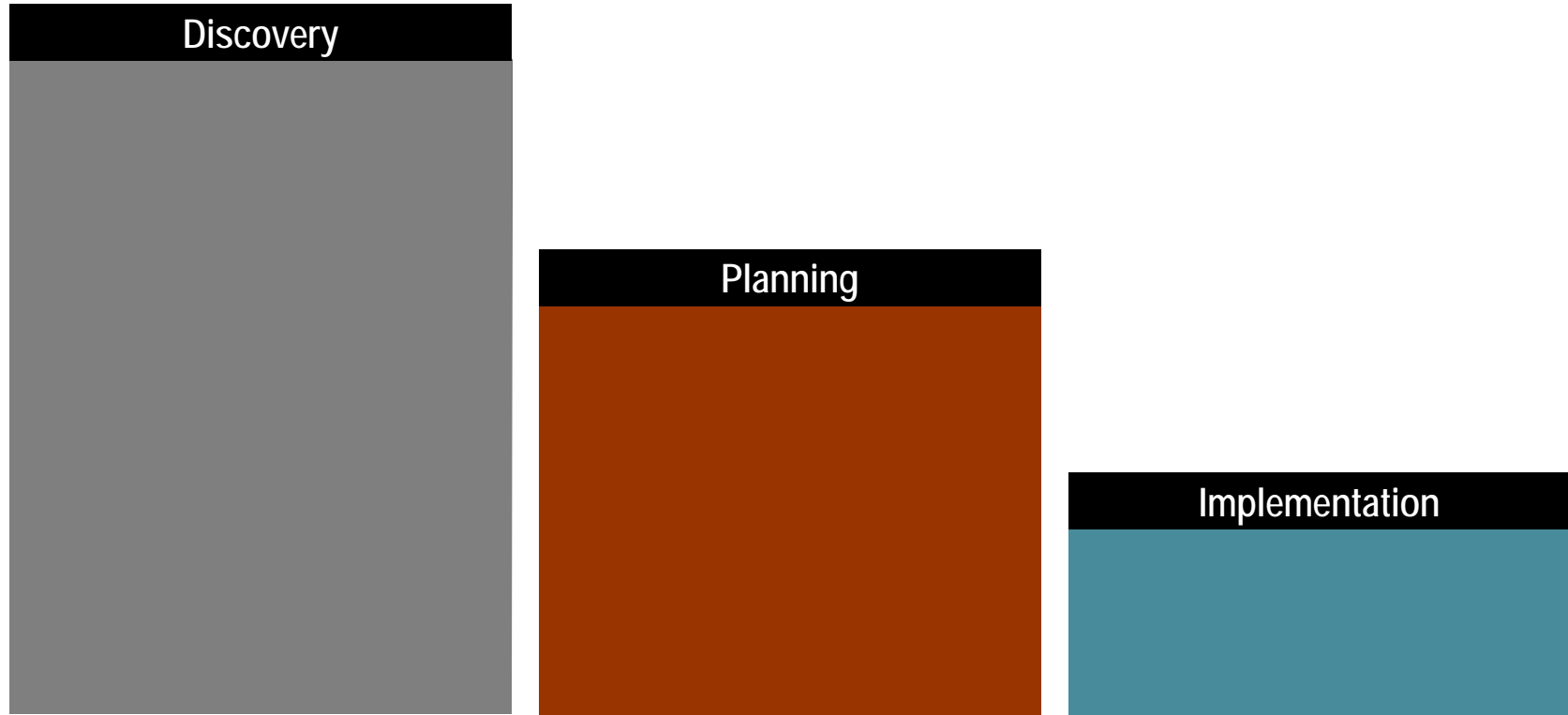
- Tenant Improvements
 - Will Lessee's opt to fund TI for lower rental rates?
 - Lessee may prefer to depreciate TI costs over their useful life (vs a longer or shorter lease term)
- Renewal Options
 - Renewal option terms will be carefully considered

Real Estate Market Implications

How will the new standards change Corporate Real Estate Strategies/Behavior and in turn how will new strategies impact the type of real estate transactions we see in the market place?

- Potential increases in “buy versus lease” decisions for real estate, since balance sheet impact is no longer such a major determining factor?
- Move to shorter term leases?
 - Shorter term leases increase volatility in future financial statements
- Trend toward “net” leases vs. “full service/gross” or “base year” lease structures
- Increased importance of renewal option provisions in leases
 - Notification dates - Tenants will want to push out as far as possible
- Fewer sale/leaseback transactions? May actually be the reverse as companies look for ways to help offset the increases on the balance sheet by converting owned assets to leased assets/ the present value of a lease is almost always less than the full property value
- Potentially more “condo-izing” of space (similar to NYC)?

Preparing your action plan






Determine data gaps

Develop RE asset profiles

PROPERTY PROFILE: Saint-Louis Park, MN



Current Total Supply	Projected Total Demand (25 years)	Variation
246	246	0%
Current Date per Location	Current Date per Location	Variation
\$ 1.00/CSF/year FSG	\$ 1.00/CSF/year FSG	\$ 0.00/CSF/year

RESIDENTIAL CHARACTERISTICS

- 1000+ Single-Family Homes
- 1000+ Attached Single-Family Homes
- 1000+ Townhomes
- 1000+ Condo/Co-ops
- 1000+ Multi-Family Units
- 1000+ Mobile Homes
- 1000+ Other Residential Units
- 1000+ Other Residential Units

RESIDENTIAL CHARACTERISTICS - 2010

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COMMERCIAL CHARACTERISTICS





- 1000+ Office Buildings
- 1000+ Retail Buildings
- 1000+ Industrial Buildings
- 1000+ Other Commercial Buildings
- 1000+ Other Commercial Buildings

COMMERCIAL CHARACTERISTICS - 2010

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- 1000+ Other Commercial Buildings

Property Cycle



Gap Assessment		HOTEL LUXE LASALLE	
Harvey Balls Quality Comparison			
Rating	Category	High Performance (Desired State)	Recommendation
	Asset inventory management system	<ul style="list-style-type: none"> Full and accurate inventory of all assets in place Physical inventory is updated regularly The location of the assets within the facilities (both site and mobile) Physical tagging of assets; uses consistent location 	<ul style="list-style-type: none"> Complete the current inventory
	Capital planning and management process	<ul style="list-style-type: none"> Processes are in place to collect capital requirements Capital manager and decision making processes are in place Forecasting and capital planning performed at a regular cadence Senior management reports are utilized to understand needs and opportunities Capital requirements are identified within a strategic plan 	<ul style="list-style-type: none"> Clarify document, and accountability process Develop roles and responsibilities for capital planning Engage in common process across regions Align Capital Planning across regions
	Cross functional C1 implementation teams	<ul style="list-style-type: none"> Formal roles and responsibilities are documented in a cross functional C1 implementation team Processes in place to ensure that cross functional implementation teams are in place for project and maintenance support 	<ul style="list-style-type: none"> Adopt and utilize C1 implementation team process Engage teams in annual refresh
	Formal training and certification programs	<ul style="list-style-type: none"> Continuous training is in place for all critical functions Individual level development plans are in place and utilized Training and development utilized as a primary tool for knowledge transfer 	<ul style="list-style-type: none"> Complete the development of curriculum materials Begin the implementation of the program Use the pattern of comparison to individualize training gaps

Develop cross functional team and processes

[illegible]

Discover, Plan & Implement

Leverage / improve
governance
framework

[illegible]

Implement
communication &
change mgt plan

Action plan

Discovery

Obtain data for day one impact

- Locate leases
- Develop abstraction standard
- Abstract lease terms and conditions

Engage with Treasury, Finance and BU's

Understand how the changes impact your financial reporting

Provide feedback and comment to FASB

Planning

Analyze organization impact

- Business unit allocations
- Capital impacts
- Compensation programs
- Resourcing needs
- Technology platform

Modify operating standards

- Structure of lease terms
- Financing strategies

Design processes

- Reporting
- Estimating
- Integration

Implementation

- Support initial financial calculations
- Integrate with BU, RE and Accounting teams for quarterly estimates
- Implement strategy for data collection and storage, reporting, and on going audit adjustments
- Support audit process
- Reporting out of lease database

Q&A

Thank you for your participation!