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)
<table>
<thead>
<tr>
<th>Time</th>
<th>Event</th>
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<tbody>
<tr>
<td>12:00 – 12:10 pm</td>
<td>Welcome and Remarks ~ Hunter Fleshood, President Carolinas Chapter</td>
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</tbody>
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| 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)                                                                      |
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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- Kevin Jenkins, *Turner Construction* (Young Leaders)

❖ **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 ≥ 75% of estimated useful life of property
      – Present Value of rents ≥ 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

- 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
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.

<table>
<thead>
<tr>
<th>Impact on Financial Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance Sheet</strong></td>
</tr>
<tr>
<td>• Right-of-use asset</td>
</tr>
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<td>• Obligation to make lease payments</td>
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<tr>
<td><strong>P&amp;L</strong></td>
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<tr>
<td>• Amortization of right-of-use asset</td>
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<td>• Interest expense</td>
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## 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 sheets$^1$:

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

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$^1$ 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

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**Profit and Loss Chart**
- Cash Out-Flow
- Straight Line Rent Exp. (old std)
- Interest & Amort (new std)

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**Balance Sheet Chart (year end balances)**
- Right To Use Asset
- Obligation to Make Lease Pmt

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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?

Future real estate decisions will be affected:

- 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

- Discovery
- Planning
- Implementation
What should I do in early 2011?

Determine data gaps

Develop RE asset profiles

Develop cross functional team and processes

Leverage / improve governance framework

Implement communication & change mgmt 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
Thank you for your participation!