

SOX Compliance

**It's impact on Site Selection Financial Analysis
5 Rules you need to know!**

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Objectives

- **Understand the impact of a Cash Flow vs. a GAAP/SOX analysis**
- **Understand how SOX fits in the real estate site selection process?**
- **Understand enough about GAAP & SOX so you will not be blindsided**

The information herein represents our interpretation of GAAP & SOX.

It is not intended to replace information received from tax and accounting professionals.

5 GAAP rules that apply to Site Selection Analysis

- 1. Rent is straight lined unless a CPI increase**
- 2. Landlord TI\$ are shown as a rent credit and
Total of Landlord and Tenant Construction Cost is depreciated**
- 3. Restoration cost is estimated and amortized over term**
- 4. GAAP rent starts earlier of when construction starts or lease commences**
- 5. Rules for sublease analysis write-offs have been further defined**

What is the \$ Impact of the 5 rules

Impacts

- 1. Income Statement & Taxes**
- 2. EBITDA / Operating Income**
(Earnings Before Interest, Taxes, Depreciation, and Amortization)
- 3. 1st Year Cost**

Impacts important because

- Changes the EPS (Earnings per Share) which is used for stock valuation**
- Impacts Taxes because timing of costs is different**
- Number 3 impacts the End-User's Budget and Bonus**

How "Costs" & Analysis are related

- **First - we need to understand the different types of financial analysis**
- **Second - we need to understand the relationship between GAAP & SOX**
- **Third - we need to review the different "cost" criteria for site selection**
- **Last - we will see an example and the "cost" comparison**

How "Costs" can be analyzed

Cash Flow

- Like a checkbook, \$ in (income), \$ out (expenses)

Accrual Accounting

- Private Companies - may use Cash or may use Accrual
- Public Companies - must use Accrual Accounting
- Timing is Key - Expenses matched to Revenue
- Costs based on a company's fiscal year
- Capital costs depreciated over their useful life
- **GAAP sets the rules used for Accrual Accounting**
 - GAAP - Generally Accepted Accounting Principles
 - Created by FASB - Financial Accounting Standards Board
- Accrual accounting is how Wall Street keeps score
 - Income Statement (Profit & Loss / P&L)
 - EPS
 - EBITDA
- Accrual accounting is how costs are charged to an end-user's budget

What is the relationship between GAAP and SOX

SOX - Sarbanes Oxley law

- **Passed by Congress in July 2002, fully effective November 2004**

Before SOX - all publicly traded companies "said" they used GAAP, and then came Enron, Tyco, Worldcom etc.

With SOX - all publicly traded companies "required" to use GAAP vs. "saying" they use GAAP

- **SOX reinforces that GAAP is the financial standard to be used**
- **Similar to BOMA setting standards for space measurement, GAAP sets standards for accounting and financial reporting.**

In terms of real estate site selection (in our opinion)

- **SOX limits creative accounting because GAAP use is required**

What is the criteria for making a site selection decision? (besides location relative to senior management's house)

- **Total Rent**
- **Total Cost**
- **NPV (net present value) - before or after taxes**
- **Capital Cost**
- **EBITDA**
- **1st year P&L cost**
 - **Impacts this year's budget**
 - **Bonus plan for end-users**
 - **Usually Pre-Tax P&L expense charged back to an end-user**
Which is based on GAAP accounting!
Cost based on fiscal year analysis

Example of GAAP vs. Cash Flow Comparison

Deal Points

Scenario:	GAAP	Cash Flow	Difference
Assumptions are the same			
Deal Points:			
Rentable SF	30,000	30,000	0
Commencement Date	3 / 2007	3 / 2007	
Lease Term (months)	66	66	0
Type of Lease	Full Service	Full Service	
Starting Rent / rsf / year	\$25.00	\$25.00	\$0.00
Months of Rent Abatement	6	6	0
Percent Rent Increase	3.0%	3.0%	0
Calendar Yr. Base Year Operating Expenses	2007	2007	
Construction Cost / rsf	\$30.00	\$30.00	\$0.00
Landlord Const. Allowance / rsf	\$21.00	\$21.00	\$0.00
Landlord Paid Const. Costs	\$630,000	\$630,000	\$0
Tenant Paid Const. Cost / rsf	\$9.00	\$9.00	\$0.00
Restoration Cost estimate / rsf	\$5.00	\$5.00	\$0.00
Averages are the same			
Average Monthly Cost (P&L PreTax)	\$69,299	\$69,299	\$0
Average Monthly Cost (P&L AfterTax)	\$45,044	\$45,044	\$0
NPV - Avg. Annual PreTax Cash Flow	\$663,324	\$663,324	\$0
Average Annual Cost (P&L PreTax)	\$831,585	\$831,585	\$0
Total Cost Over Term (P&L PreTax)	\$4,573,716	\$4,573,716	\$0

Example of GAAP vs. Cash Flow Comparison

Annual Cost Comparison

P&L/Income Statement & EBITDA different

Year	2007	2008	2009	2010	2011	2012	Total
GAAP (lease starts 3 / 2007) 30,000 rsf							
EBITDA	539,633	655,660	664,003	672,596	681,447	460,376	3,673,716
P&L (Total Cost): Pre Tax	675,997	819,296	827,639	836,233	845,084	569,467	4,573,716
Cash Flow (lease starts 3 / 2007) 30,000 rsf							
EBITDA	250,000	776,850	808,256	840,603	873,921	754,086	4,303,716
P&L (Total Cost): Pre Tax	520,000	776,850	808,256	840,603	873,921	754,086	4,573,716
Difference							
EBITDA - Numbers reported to Wall St.	289,633	(121,190)	(144,253)	(168,007)	(192,474)	(293,710)	(630,000)
P&L (Total Cost): Pre Tax - End User's Budget	155,997	42,446	19,384	(4,371)	(28,838)	(184,619)	0

**GAAP vs. Cash Flow Impact
Landlord TI\$ Rent Credit**

**GAAP vs. Cash Flow Impact
Timing of rent & restoration**

Example of GAAP vs. Cash Flow Comparison

Scenario:	GAAP	Cash Flow	Difference
P&L/Income Statement & EBITDA different			
P&L PreTax Cost in 2007, starting 3 / 2007	\$675,997	\$520,000	\$155,997
Total Rent over Term	\$3,411,580	\$4,041,580	\$(630,000)
Capital Investment	\$270,000	\$270,000	\$0
EBITDA	\$3,673,716	\$4,303,716	\$(630,000)
PreTax Cash Flow NPV @ 8%	\$3,648,279	\$3,648,279	\$0
AfterTax Cash Flow NPV @ 8% (Taxes @ 35%)	\$2,350,721	\$2,371,382	\$(20,661)

GAAP vs. Cash Flow Impact
Timing of rent & restoration

GAAP vs. Cash Flow Impact
Landlord TI\$ Rent Credit

GAAP vs. Cash Flow Impact
Timing of P&L costs

5 GAAP/SOX Rules You Need to Know

1. Rent straight-lined (e.g. averaged) over the term if rent increases are known.

Impact: First Fiscal year cost will increase

What if a CPI increase?

What if free rent and a CPI increase?

2. Landlord Tenant Improvement \$ are shown as a net rent credit, and Total construction cost including Landlord's TI\$ is depreciated.

Assume: Construction cost is \$30/sf, Landlord paying \$21/sf

Old days: Depreciate \$9/sf (part paid by tenant)

New days: Depreciate \$30/sf (tenant and landlord cost)
Landlord cost shown as credit to rent spread over term
Tenant's capital stays at \$9/sf (\$30 - \$21)

Why? Rationale - base rent includes landlord's amortization of TI\$

Impact: Reduces "rent" charged to the P&L
Increases depreciation
Changes EBITDA

5 GAAP/SOX Rules You Need to Know - CONTINUED

3. GAAP rent starts with "beneficial use"

GAAP rent starts earlier of when construction starts or lease commences

Assume: Lease starts March 2007, construction starts January 2007

Old days: Start paying costs in March 2007

**New days: GAAP rent starts when you "use" the space
e.g. January 2007**

**Why? Tenant, in essence, controls space
since construction is for Tenant's use**

**Impact: Potential double rent on financial statements
during construction (if relocating)
First Fiscal year cost will increase**

4. Restoration amortized over term

aka - "make good" or in UK, called dilapidations

Estimate the cost and amortize (average) it over the term

Adjust Cash Flow at the end of term to include Restoration cost

Impact: Increases average annual occupancy cost on P&L

5 GAAP/SOX Rules You Need to Know - CONTINUED

5. Rules for sublease analysis write-offs have been further defined

- **Cost written off when decision made.**
When vacate space or if vacant, when decide to sublease
- **Costs include NPV of rental costs, depreciation write-off, estimated subleasing costs and sublease income**
- **Income Statement (P&L) charged the NPV of write-off**
- **Monthly, interest expense on declining balance of the NPV Write-Off charged to P&L**
- **Declining balance determined by taking net monthly costs and interest expense, deducting that from the NPV write-off**

- **Seriously complex!**

GAAP vs. Cash Flow Comparison

Scenario:	GAAP w/New Start Date	Cash Flow	Difference
Timing Adjusted for earlier start date			
Deal Points:			
Rentable SF	30,000	30,000	0
Commencement Date	1 / 2007	3 / 2007	
Lease Term (months)	68	66	2
Type of Lease	Full Service	Full Service	
Starting Rent / rsf / year	\$25.00	\$25.00	\$0.00
Months of Rent Abatement	8	6	2
Percent Rent Increase	3.0%	3.0%	0
Calendar Yr. Base Year Operating Expenses	2007	2007	
Construction Cost / rsf	\$30.00	\$30.00	\$0.00
Landlord Const. Allowance / rsf	\$21.00	\$21.00	\$0.00
Landlord Paid Const. Costs	\$630,000	\$630,000	\$0
Tenant Paid Const. Cost / rsf	\$9.00	\$9.00	\$0.00
Average Monthly Cost (P&L PreTax)	\$67,553	\$69,299	\$(1,745)
Average Monthly Cost (P&L AfterTax)	\$43,910	\$45,044	\$(1,135)
NPV - Avg. Annual PreTax Cash Flow	\$638,076	\$663,324	\$(25,247)
Average Annual Cost (P&L PreTax)	\$810,640	\$831,585	\$(20,945)
Total Cost Over Term (P&L PreTax)	\$4,593,625	\$4,573,716	\$19,909
P&L PreTax Cost in 2007, starting 1 / 2007	\$784,113	\$520,000	\$264,113
Total Rent over Term	\$3,431,489	\$4,041,580	\$(610,091)
Capital Investment	\$270,000	\$270,000	\$0
EBITDA	\$3,693,625	\$4,303,716	\$(610,091)
PreTax Cash Flow NPV @ 8%	\$3,615,765	\$3,648,279	\$(32,514)
AfterTax Cash Flow NPV @ 8% (Taxes @ 35%)	\$2,321,289	\$2,371,382	\$(50,092)

Different "Start Date"

Timing Adjustment

Free Rent during Const.

IMPACT of GAAP w/Timing Adjustment

GAAP vs. Cash Flow Comparison

Annual Cost Comparison

Comparing
Cost per Year
w/adj. Start Date

Timing Adjusted for earlier start date

Different
"Start Date"

Year	2007	2008	2009	2010	2011	2012	Total
GAAP w/New Start Date (lease starts 1 / 2007) 30,000 rsf							
EBITDA	647,749	636,758	645,101	653,695	662,546	447,775	3,693,625
P&L (Total Cost):							
Pre Tax	784,113	800,395	808,738	817,331	826,182	556,866	4,593,625
After Tax	509,673	520,257	525,680	531,265	537,018	361,963	2,985,856
CASH FLOW:							
Pre Tax	520,000	780,600	812,118	844,582	878,019	758,306	4,593,625
After Tax	245,560	500,462	529,060	558,516	588,855	563,403	2,985,856
NPV - PreTax Cash Flow @ 8%							3,615,765
NPV - AfterTax Cash Flow @ 8%							2,321,289
Cash Flow (lease starts 3 / 2007) 30,000 rsf							
EBITDA	250,000	776,850	808,256	840,603	873,921	754,086	4,303,716
P&L (Total Cost):							
Pre Tax	520,000	776,850	808,256	840,603	873,921	754,086	4,573,716
After Tax	338,000	504,953	525,366	546,392	568,049	490,156	2,972,915
CASH FLOW:							
Pre Tax	520,000	776,850	808,256	840,603	873,921	754,086	4,573,716
After Tax	338,000	504,953	525,366	546,392	568,049	490,156	2,972,915
NPV - PreTax Cash Flow @ 8%							3,648,279
NPV - AfterTax Cash Flow @ 8%							2,371,382
Difference							
EBITDA - Numbers reported to Wall St.	397,749	(140,092)	(163,154)	(186,908)	(211,375)	(306,311)	(610,091)
P&L (Total Cost):							
Pre Tax - End User's Budget	264,113	23,545	482	(23,272)	(47,739)	(197,220)	19,909
After Tax	171,673	15,304	314	(15,127)	(31,030)	(128,193)	12,941
CASH FLOW:							
Pre Tax		3,758	3,863	3,978	4,098	4,221	19,909
After Tax	(92,440)	(4,491)	3,694	12,124	20,806	73,248	12,941
NPV - PreTax Cash Flow @ 8%							(32,514)
NPV - AfterTax Cash Flow @ 8%							(50,092)

Wall Street
Numbers

Impact of GAAP w/adj.
Start Date vs. Cash Flow

End User's
Budget Delta

Advice: Close vs. "Perfect" and Taxes

- In doing an analysis, how close to "perfect" is close enough?
 - It's all about the assumptions, and they are assumptions, not facts
 - Analysis objective is to provide "An Informed Decision" and be "approximately correct"
- Taxes
 - Corporations have Tax Departments to tweak the numbers
 - Individuals/small companies use CPA's, who tweak the numbers
- Close is more than good enough!

5 GAAP Rules Impacting Site Selection

- **Rent is straight lined unless a CPI increase**
- **Landlord TI\$ are shown as a rent credit and
Total of Landlord and Tenant Construction Cost is depreciated**
- **Restoration cost is estimated and amortized over term**
- **GAAP rent starts earlier of when construction starts or lease commences**
- **Rules for sublease analysis write-offs have been further defined**

Other Considerations

- **Cost analysis based on tenant's fiscal year**
- **Major impact is on first year "cost"**
- **GAAP sublease analysis is very complex**
- **Don't sweat taxes, focus on making an informed decision**

About LseMod

- **Cash Flow analysis tools - e.g. LseMod Tenant Rep
Total Cost, Before Tax NPV**
- **GAAP/SOX analysis tools - LseMod Pro
Total Cost, EBITDA, P&L, Before and After Tax NPV**
- **Designed for Informed Decision Making**
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