NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

November 1, 2004

Mr. Lawrence W. Smith
Director of Technical Applications and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

File Reference No. EITF0313

Dear Larry:

Executive Summary

The National Association of Real Estate Investment Trusts (NAREIT) has reviewed the draft of EITF Abstract Issue 03-13 (the Abstract) and believes that the current application of Statement of Financial Accounting Standards 144 *Accounting for Impairment or Disposal of Long-Lived Assets* (SFAS 144) to real estate companies that own and operate investment property creates an issue that is very similar to the conceptual and reporting issues that the Abstract addresses. The fundamental issue is that the cash inflows and/or outflows eliminated by dispositions of many investment properties are replaced through the acquisition of like-kind properties and, therefore, reporting these regular dispositions as discontinued operations does not faithfully represent the financial impact of the business transaction on the reporting entity.

NAREIT is the national trade association for real estate investment trusts (REITs) and other publicly traded real estate companies. Members include REITs and other businesses that develop, own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses. The business of developing, owning and operating income-producing property regularly involves the disposition of individual or groups of properties from a company's portfolio and the replacement of these properties with like-kind properties. In this context, the accounting standards for property dispositions are important to producing useful and relevant financial reports for publicly traded real estate companies.

The current interpretation and application of SFAS 144 to companies that own and operate investment property has produced financial statements that are at best confusing and potentially misleading. The manner in which SFAS 144 is being applied to real estate has resulted in virtually every property sale being reported in *Discontinued Operations.* This reporting, which requires the constant

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reclassification of operating results, has given financial statement users the impression that there may be a change in the business plans of the reporting entity and, as a result, a significant change in prospective operating results. In the great majority of cases, this is not true. As further discussed below, real estate companies that own and operate investment property regularly dispose of mature properties in order to reinvest the capital raised by the disposition in properties having greater profit potential. The cash flows generated by the replacement property result in “migration” as used in paragraph 6.a. and defined in footnote 3 of the Abstract. NAREIT requests that the EITF consider expanding the discussion in the Abstract to clarify that its guidance may be applicable to components whose cash flows are replaced by cash flows from similar components – regardless of the similarity of customers and geographic region.

Discussion

NAREIT responded to the original exposure draft of SFAS 144 and followed up that response with a letter to the FASB’s Director of Research and Technical Activities on December 27, 2001. A copy of each of these letters is attached.

The follow-up letter fully explains issues created by the requirement that virtually every investment property qualifies as a “component” as defined by the standard. The core issue is that the current application of SFAS 144 to most companies that own and operate investment property is causing confusion as to the reporting entity’s business plans and its future cash flows. These companies regularly recycle capital through the disposition of more mature properties and reinvesting the proceeds in properties having greater cash flow potential. In many cases, the same tenants lease space in the property disposed of and the replacement property. This is especially true of larger REITs who maintain relationships with national and international office and retail tenants. While this capital recycling enhances future cash flows, the resulting cash flows are generated by the ongoing rental of space in similar properties and, in some cases, to the same tenants. We believe that the results of this recycling are very similar to the “migration” of cash flows as discussed in paragraph 6, footnote 3 of the Abstract and that they produce similar reporting issues.

The definition of “migration” indicates “ there is a presumption that if the ongoing entity continues to sell a similar commodity on an active market after the disposal transaction, the revenues (or) costs would be considered a migration.” This is precisely what is occurring with respect to many real estate companies. The rental revenue stream from renting space [the industry’s commodity] continues after the disposition through the acquisition and rental of similar property.

Reporting these regular sales of properties as discontinued operations gives financial statement users the impression that the recurring disposition of properties is not an integral and regular part of owning and operating an investment property company. In reality the disposition of an investment property by an investment property company represents the regular realization of value created and enhanced through the effective leasing and management of properties by the entity. The proceeds from these dispositions are reinvested in comparable properties producing the same benefit, often times to the same user or types of user. This is similar to any manufacturer that creates value in excess of the costs of products within a short-term period. The difference is that, during the operating period, the owner of investment property receives rental revenue.

A recent study of dispositions by 144 public REITs, representing 77% of all public REITs and 89% of the REIT market by equity market capitalization, indicates that, during 2001, 2002 and 2003 (432 annual reporting periods) gains/losses from property dispositions were reported in 276, or 64%, of the periods. Fifty-five of the 144 companies reported gains/losses in each of the three years. Similarly, "discontinued operations" were reported in 63% of the periods and 62 companies reported "discontinued operations" in all three periods. The great majority of these dispositions represent the regular recycling of capital into similar investment properties.

Other Considerations

Global Convergence

The International Accounting Standards Board recently issued International Financial Reporting Standard No. 5 *Non-current Assets Held for Sale and Discontinued Operations* (IFRS 5). Question 8 of the exposure draft of this standard requested that respondents specifically provide their views with respect to "classification as a discontinued operation." The question raised the issue of reporting regular sales of immaterial components as discontinued operations and included the following discussion:

> *The Exposure Draft proposes that a discontinued operation should be a component of an entity that either has been disposed of, or is classified as held for sale, and:*
> *(a) the operations and cash flows of that component have been, or will be, eliminated from the ongoing operations of the entity as a result of its disposition, and*
> *(b) the entity will have no significant continuing involvement in that component after its disposal.*
>
> *A component of an entity may be a cash-generating unit or any group of cash-generating units. (See paragraphs 22 and 23.)*
>
> *These criteria could lead to relatively small units being classified as discontinued (subject to their materiality). Some entities may also regularly sell (and buy) operations that would be classified as discontinued operations, resulting in discontinued operations being presented every year. This, in turn, will lead to the comparatives being restated every year. Do you agree that this is appropriate? Would you prefer an amendment to the criteria, for example adding a requirement adapted from IAS 35 Discontinued Operations that a discontinued operation shall be a separate major line of business or geographical area of operations, even though this would not converge with SFAS 144 Accounting for the Impairment or Disposal of Long-Lived Assets. How important is convergence in your preference?*

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Are there other aspects of these criteria for classification as a discontinued operation (for example, the elimination of the operations and cash flows) appropriate? If not, what criteria would you suggest, and why?

NAREIT responded to this exposure draft indicating that it preferred that the results of regular sales of insignificant components not be reported as discontinued operations. The comment letter suggested that the rules of classification as a discontinued operation should only apply to significant components of an entity's business and not to individual sales of long-lived assets. A copy of this comment letter is attached. On March 31, 2004, the IASB issued IFRS 5. In the final rule, the IASB agreed with the comments expressed by NAREIT and others by concluding that a discontinued operation should be a major line of business or geographical area of operations.

While we understand that the Issue 03-13 is not intended to reconcile international standards with U.S. GAAP, we do not understand why the EITF would issue guidance that confirms accounting practice that is so inconsistent with the March 2004 IASB conclusions. In fact, it seems contrary to the FASB's commitment to the global harmonization of reporting standards to issue this Abstract without more broadly considering the criteria for reporting a disposition as a discontinued operation. Consideration of Issue 03-13, together with the most recent thinking of international standards setters with respect to reporting discontinued operations, provides the EITF an opportunity to enhance global standards harmonization and eliminate a significant issue creating conflict between the U.S. and international standards.

Rules-Based vs. Principles-Based Standards

In addition to conclusions in the draft of the Abstract perpetuating differences between U.S. and international standards, the Abstract is highly rules-based rather than principles-based. As indicated in the first paragraph of this letter, the Abstract provides a number of narrow rules that may modify the application of SFAS 144 to some extent without addressing more broadly the issue of reporting dispositions where entity cash flows are replaced. More specifically, the requirement that new cash flows must be generated from "specific customers of the disposed component" (lessees in our industry's case) and in the same geographic region does not address the situation in which the entity's cash flows are replaced through the sale/lease of similar products. Establishing these arbitrary rules also seems contrary to the FASB's announced movement toward principles-based standards.

Administrative and Audit Complexity

Reporting regular dispositions of insignificant components as discontinued operations and continually reclassifying previously reported operating results creates administrative burdens, complications in communicating operating results and complexities with respect to the audit process. Focusing on the external audit process, an entity's audit firm must audit these regular reclassifications. This becomes especially burdensome in the process of obtaining comfort letters when issuing securities. Further, many in the financial community believe that rotation of audit firms by public companies may be in the best public interest. Based on a great deal of experience when it was necessary to appoint new auditors to replace Arthur Andersen LLP, the new auditor was not allowed to rely on the Andersen opinion on prior periods when elements of prior period financial statements were restated or reclassified. This additional audit burden and cost may be a hurdle to auditor rotation.

Summary

NAREIT respectfully requests that the EITF consider broadening its evaluation of issues created by reporting regular, insignificant dispositions as discontinued operations – especially when cash flows from disposed properties are replaced through the acquisition of similar properties.

If you have any questions regarding this request or if we can support a positive response to this request, please contact me at 202-739-9432 or gyungmann@nareit.com.

Sincerely,

George L. Yungmann
VP, Financial Standard