NAREIT Financial Standards Update

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Financial Standards Update

FASB and IASB Move Closer to Agreeing with NAREIT's Petition to Redefine Discontinued Operations

During 2006, NAREIT petitioned the Financial Accounting Standards Board (FASB) to modify U.S. GAAP standards for reporting discontinued operations in order to eliminate the need to report virtually every sale of an investment property as discontinued operations. In its petition, NAREIT suggested that a solution to our industry's reporting anomaly would be for U.S. GAAP to converge with International Financial Reporting Standards (IFRS) that define discontinued operations. During the January 24 and 25, 2007 FASB and International Accounting Standards Board (IASB) meetings, both Boards concluded that the definition of discontinued operations should require that dispositions of entire operating segments of an entity be the lowest level of dispositions that would require discontinued operations financial reporting. This conclusion mirrors NAREIT's recommendation.

In addition, NAREIT has requested that the FASB and IASB expedite their respective due processes in order to accelerate resolution of this reporting issue outside of the long-term but related Financial Statement Presentation project (see article below). At their respective April 2007 meetings, the Boards agreed to NAREIT's request and concluded that their due processes with respect to defining "discontinued operations" will occur separately but in tandem with the issuance of a "preliminary views document" covering the related Financial Statement Presentation project. These processes will solicit constituent views during 4Q07 and 1Q08.

Highlights

Therefore, any modification to the discontinued operations definition would probably not be effective until 2009.

Background

In August 2001, the FASB issued Statement 144 *Accounting for the Impairment or Disposal of Long-Lived Assets*. Under this standard, virtually every sale of an investment property or group of properties must be reported as "discontinued operations." Reporting under the standard requires regular reclassification of earnings between income from continuing operations and income from discontinued operations. This standard has created an undue financial reporting burden on the real estate industry as well as substantial confusion to users of these companies' financial statements. As a result, in May 2006 NAREIT representatives met with the FASB to discuss possible solutions for the industry. The FASB staff completed substantial research with respect to NAREIT's request during the summer and fall of 2006.

As indicated above the Boards have reached tentative agreement that:

- A component of an entity that has been (or will be) disposed of and meets the definition of an operating segment under Statement 131 and IFRS 8 would be reported as a discontinued operation on the face of the financial statements.

- For all components of an entity that have been (or will be) disposed of, including those reported as a discontinued operation, the guidance would require additional financial information to be presented in the notes to the financial statements for all periods presented.

Recent Related Developments

In a somewhat related development, on April 25 the European Parliament blocked a European Commission plan to adopt into law IFRS 8 *Operating Segments* that would converge the international standard for reporting a company's business segments with the U.S. standard, FAS 131 *Disclosures about Segments of an Enterprise and Related Information.* While IFRS generally provides principles-based guidance for reporting financial information on business segments and provides for a management's approach to designing the information, the Parliament took the position that the standard is not definitive enough to result in consistent reporting among companies. The Parliament has deferred a vote on the acceptance of IFRS 8 into law until September to give the Internal Market Commission an opportunity to develop more convincing support for acceptance. It is unclear whether this action by the European Parliament will affect the convergence of the discontinued operations definition discussed above.

President Bush and EU President Reach a Financial Services Agreement that Could Accelerate the Option to Report Investment Property at Fair Value

On April 30, President Bush and Angela Merkel, current President of the European Union, agreed on proposals that would increase regulatory cooperation and implement accounting proposals that would streamline regulations with respect to cross-border capital flows. Of particular importance is the proposal to eliminate the need for foreign companies to reconcile financial statements based on IFRS with U.S. GAAP in filings with the Securities and Exchange Commission (SEC or Commission) by no later than 2009. Click HERE to access the White House release related to this agreement.

In line with this proposal, on April 24, 2007 the SEC announced that it will consider allowing U.S. companies to file financial reports based on IFRS. Click HERE to view the SEC's press release.

If U.S. companies are allowed to base their financial statements on IFRS, real estate companies would have the opportunity to report investment property at fair value. Reporting properties at fair value would result in the elimination of depreciation expense related to these properties and the inclusion of unrealized gains or losses in net income.

In addition to providing an opportunity to report investment property at fair value, companies would have the opportunity to report under substantially "principles-based" standards reflected in IFRS rather than "rules-based" standards inherent in U.S. GAAP.

EITF Continues to Debate Convertible Debt Accounting Guidance

In the March 15, 2007 Emerging Issues Task Force (EITF) meeting, the EITF continued to discuss Issue 07-2, *"Accounting for Convertible Debt Instruments That Require or Permit Partial Cash Settlement upon Conversion"* which proposes changes to accounting for Convertible Bonds. The original guidance, Issue 90-19, provides accounting and earnings per share guidance for three types of structured convertible debt instruments. The third instrument, or Instrument C, which is the subject of EITF 07-2, would require the issuer to settle the principal in cash but would allow the issuer to settle the conversion spread in either cash or stock.

Several amendments have already been made to Issue 90-19. In the first amendment, which was made in 1991, the EITF determined that Instrument C should be considered an indexed debt and not convertible debt. In 2002, the EITF reversed its opinion again and determined that Instrument C should be considered convertible debt. More recently, with the extensive issuance of such instruments, the EITF is considering a third amendment to the original guidance that they believe would better reflect the true economics of the instruments.

The EITF is focusing on two major issues. First, how should a convertible debt instrument that requires or permits partial cash settlement upon conversion be accounted for if the embedded option does not fall within the scope of Statement 133, *Accounting for Derivative Instruments and Hedging Activities?* Second, is the EITF the appropriate body to address this issue?

A subcommittee of the EITF is being formed to address these issues and findings will be presented at the June 13-14, 2007 EITF meeting. For more information, click HERE.

SEC Reaffirms its Commitment to Make the Implementation of Section 404 Effective and Cost Efficient

Background

On April 4, 2007, the SEC reaffirmed its commitment to the SEC staff's December 2006 proposal to reshape the Sarbanes-Oxley regulations, specifically Section 404. The proposal is designed to make the audit and internal control review process more efficient. These recommendations would ease the burden on all publicly traded companies but would particularly aid smaller organizations that are scheduled to begin complying with the existing requirements this year.

SEC Chairman Christopher Cox

The Commissioners directed the staff to concentrate on several topics during their next phase of the project. First, the SEC will continue to align Public Company Accounting Oversight Board (PCAOB) guidance, Audit Standard 5 (AS-5), with SEC rules. The proposed AS-5 was issued simultaneously with the December 2006 SEC proposal and focuses on "prescriptive requirements, definitions and terms." The SEC staff will also pay particular attention to the ability of auditors to scale 404 audits under AS-5 to the size and characteristics of companies, and will encourage the use of top-down risk-based assessments. Finally, the SEC intends to put forward a principles-based approach that will, among other items, guide the auditor when determining whether the result of management's assessment of controls can be utilized when making an independent auditor assessment.

The Commission is expected to vote on the revised PCAOB auditing standard by June 2007, which would allow companies and auditors sufficient time to integrate the changes into their year-end 2007 audits. Under the Sarbanes-Oxley Act, PCAOB standards cannot take effect until the Commission approves the proposal. The SEC press release announcing this latest action is available by clicking HERE.

Comment Letters

210 comment letters were submitted to the SEC in response to its December 2006 proposed guidance. The SEC found most comments to be in support of the Commission's efforts. Specifically, commentators agreed that the guidance would further empower management toward assuming responsibility for the design and testing of internal controls. Comment letters also indicated that the proposal would provide much needed specificity that was lacking in the original guidance.

Highlights of comments include:

- Aligning the SEC and PCAOB proposals. This was an overarching issue discussed in NAREIT's comment letters.

- Reconciling terminology differences between the SEC and PCAOB proposals including "material weakness," "entity" vs. "company level controls," "significant account" vs. "relevant assertion," and "financial reporting elements" vs. "financial reporting risk."

- Allowing and encouraging increased communication between the auditor and the company. Several large, accounting firms commented that the ability for the auditor to use the company's documentation as evidential matter to support their opinion would increase efficiencies greatly.

- Aligning the SEC and PCAOB guidance with respect to strong indicators of a material weakness. This issue was singled out due to the critical nature of the content.

- Giving additional guidance on the risk assessment process, the treatment of lower risk items, and the concepts of certain kinds of controls – financial, entity level, monitoring, and information technology controls. Others commented that additional emphasis should be placed on controls that would prevent or detect fraud.

The summary of comments is available by clicking HERE and click HERE for NAREIT's submission.

In addition to its independent work to reform Sarbanes-Oxley requirements, NAREIT representatives are active members of the U.S. Chamber of Commerce's Sarbanes-Oxley Association Working Group.

Real Estate Industry Coalition Continues to Develop a Global Financial Statement Model

In 2005, the FASB and IASB established a joint project *Financial Statement Presentation* that aims to establish new standards for the content and form of each of the basic financial statements. These statements include the statements of net income and comprehensive income, statements of changes in shareholders' equity, statements of cash flow and statements of financial position.
This international convergence project presents an opportunity for the real estate industry and NAREIT to seek model financial statements that effectively report the economics of the business of acquiring, developing, owning and operating investment property. For example, as part of this

initiative, representatives from the IASB, FASB and SEC will be considering whether the performance of "core operations" should be reported under a uniform definition or under a more flexible "management approach." The management approach would require that earnings from "core operations" be reported in a manner that reflects how management views operating performance.

Because any final standard will affect the reporting by real estate companies around the world, NAREIT is working with a coalition of real estate organizations outside the U.S. toward developing a global real estate financial reporting model. Organizations forming the coalition include:

- Asian Public Real Estate Association
- Association for Real Estate Securitization of Japan
- British Property Federation
- European Public Real Estate Association
- Property Council of Australia
- Real Property Association of Canada

Through meetings and conference calls, the coalition has developed a preliminary consensus as to the content and format of the Statement of Net Income. The consensus would, if adopted, include consolidated metrics similar to what the U.S. industry currently labels "net operating income" and "funds from operations." The coalition will meet on May 24 and 25, 2007 at NAREIT's office in Washington, D.C. to finalize a consensus with respect to the content and format of the Statement of Net Income. Also at this meeting, the coalition will begin to develop a consensus with respect to the content and form of the other basic financial statements. The financial statement model developed by the coalition will be discussed with NAREIT's Best Financial Practices Council and Executive Committee.

IASB/FASB Consider New Paradigm for Lease Accounting

On June 15, 2005, the SEC issued a report entitled *Report and Recommendations Pursuant to Section 401c of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities and Transparency of Filings by Issuers.* The report discusses the implications of off-balance sheet accounting, including consolidation issues, transfers of financial assets with continuing involvement, retirement arrangements, contractual obligations, leases, contingent liabilities and derivatives, and the use of special-purpose entities. Of particular significance to NAREIT members, the report indicated that there may be approximately $1.25 trillion in future lease obligations that are not recognized as liabilities on lessees' balance sheets and recommended that guidance on accounting for leases be reconsidered.

In April 2006, the FASB and IASB agreed to add a joint project to their agenda with the first phase primarily involving the staff working with a group of individuals having extensive experience with lease agreements and accounting for them. George Yungmann, NAREIT Senior Vice President, Financial Standards, is one of eighteen global representatives who have been appointed to serve on the Boards' Lease Accounting Working Group. The Boards intend to solicit constituent views through the issuance of a "preliminary views document" covering lessor and leseee accounting in 2Q08.

Of major concern to our industry is whether new standards will re-characterize investment property on the balance sheet and/or re-characterize rents

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reported in lessors' income statements. Recent international studies have suggested that lessors should report assets being leased as two elements in the balance sheet:

- Lease receivables, and
- Interests in lease residuals

Rental payments received from lessees would be accounted for as debt service on the lease receivable and be reported as two elements – interest income on the income statement and a reduction of the lease receivable.

This project was discussed at a joint meeting of the FASB and IASB on April 24, 2007. The staff memorandum, *Leases*, which formed the basis for this discussion indicated that the Boards would need to consider the impact of a change in lease accounting standards on the accounting for investment property under IAS 40 *Investment Property*. The narrow question is how to define investment property if the distinction between "operating" and "finance" leases disappears under a new lease accounting standard. IAS 40 includes in the definition of investment property that the property must be leased under operating leases. This question dealing with IAS 40 may have been triggered by NAREIT's input at the February 15, 2007 Lease Accounting Working Group meeting and the IASB representative's response that the IASB would have the staff examine the interaction between IAS 40 and any potential change in lease accounting.

SEC Continues its Efforts to Increase the Efficiency of Raising Capital in the U.S. Capital Markets

The SEC's rhetoric continues to reaffirm its efforts to ease the financial reporting burden on foreign companies and foreign investors. In a recent speech, Commissioner Roel C. Campus discussed three initiatives in which the SEC has attempted to be more accommodating while simultaneously protecting investors.

Sarbanes-Oxley

In his March 8 addresses entitled *SEC Regulation Outside the United States* (London, England) and *Remarks Before the Association Française des Entreprises Privées* (Paris, France) Commissioner Campus described the SEC's attempt to demonstrate flexibility when, in December 2006, it proposed changes to its rules that govern compliance with the Sarbanes-Oxley Act. These changes are meant to "fix" many of the implementation issues that have plagued companies over the past three years and driven implementation costs above originally anticipated levels.

GAAP-IFRS

The SEC has reaffirmed its commitment to the "roadmap," the movement toward one set of global accounting standards. This roadmap, when implemented, would eliminate the current SEC requirement for reconciliation between financial statements prepared on the basis of IFRS and amounts that would have been reported under U.S. GAAP. Interestingly, the SEC has indicated that, if it allows foreign filers to base their financial reports on IFRS without reconciliation to U.S. GAAP, domestic companies may be allowed to adopt IFRS as the basis of financial reports filed with the Commission.

Foreign Private Issuer Deregistration

The SEC has also decided to abandon the public float test and is utilizing the trading volume test that would allow foreign private issuers to deregister if the U.S. trading volume is less than 5% of the issuer's trading volume in the home market. Campus believes this change would allow the U.S. markets to more effectively compete globally. The Commission is also considering modifying the denominator used for the trading volume test to include worldwide trading volume, based on the suggestion of many commenters.

Campus outlined other changes that are currently being considered. Click HERE and HERE to access the two speeches.

A study related to this question, *Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing Choices over Time,* completed by a number of scholars from Canada and the United States and the European Corporate Governance Institute concluded that Sarbanes-Oxley has had no impact on the number of cross-listing counts on U.S. exchanges. This study can be accessed by clicking HERE.

FASB to Issue Third Exposure Draft on Accounting for Earnings Per Share

As a part of its short-term convergence effort with the IASB, the FASB is issuing its third exposure draft, which proposes changes to the calculation of earnings per share (EPS). The exposure draft is scheduled to be released for comment at the end of the second quarter of 2007.

In 2002, the joint project was added to the short-term convergence efforts in order to address the remaining differences between International Accounting Standard (IAS) 33, *Earnings per Share*, and FASB Statement of Financial Accounting Standards (FAS) No. 128, *Earnings per Share*.

The major remaining significant obstacle requiring focus from the joint Boards relates to an instrument that can be settled with either cash or stock and is classified as a liability on the balance sheet. Modifications to the treasury stock method are also being contemplated. The Board has tentatively decided that instruments that can be settled in cash or shares, are classified as a liability, and are marked-to-market with gains or losses recognized in earnings would no longer be subject to the treasury stock method, the if-converted method or the two-class method. The Boards determined that the dilutive effect of these types of instruments is already captured through the use of fair value and effectively eliminates the need to include them in the calculation of diluted EPS.

Other preliminary findings and project information can be found by clicking HERE and HERE.

NAREIT will form a task force to evaluate the exposure draft and consider whether NAREIT should comment on the proposed guidance. Anyone interested in participating in this task force should contact Andrea Perlak at aperlak@nareit.com.

Upcoming NAREIT Financial Standards Events:

Internal Auditor Forum

NAREIT's 2007 Internal Auditor Forum will be held in Santa Monica, California, on August 21 and 22, 2007. We want to thank Macerich for agreeing to sponsor this event, which will be held at its headquarters office. The program is designed exclusively for individuals who direct the internal audit function. Participants in previous years' Forums have found this event very helpful to the effectiveness of their companies' internal audit function. Program and registration information will be available shortly. For more information, please contact Andrea Perlak at aperlak@nareit.com or (202) 739-9442.

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Retail Sector Operations Accounting Forum

Building on the inaugural success of the Retail Sector Operations Accounting Forum held in August 2006 in Cleveland, NAREIT's Second Annual Retail Sector Operations Accounting Forum will be held sometime in the middle of August 2007. Last year, over 60 professionals attended and, based on overwhelmingly positive feedback, participation is anticipated to increase. The event location has tentatively been determined to be in either Jacksonville, FL or the New York City area. If you are interested in participating in planning this event, please contact Andrea Perlak at aperlak@nareit.com or (202) 739-9442.

XBRL Webcast – XBRL, Real Benefits or Just More Regulation?

The Accounting Committee meeting that was held in connection with NAREIT's recent Law & Accounting Conference included a presentation of Extensible Business Reporting Language (XBRL). The advantages of reporting financial information using XBRL have been widely discussed among participants in the global financial markets. Christopher Cox, SEC Chairman, Bob Herz, FASB Chairman and David Tweedie, IASB Chairman are among the many proponents of XBRL. Chairman Cox has indicated that the SEC intends to issue a proposal during 2008 with respect to requiring the use of XBRL in SEC filings.

We believe that many NAREIT members are interested in better understanding XBRL. To respond to this interest, NAREIT intends to arrange a webcast that would provide participants a thorough understanding of this cost effective reporting and analytical tool. An outline of topics to be covered in the webcast and the date and time of this presentation will be distributed shortly.

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