NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

July 9, 2003

Robert H. Herz, Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Subject: Proposed Statement of Position: *Accounting for Certain Costs and Activities Related to Property, Plant and Equipment*

Dear Mr. Herz:

The National Association of Real Estate Investment Trusts (NAREIT) is seriously concerned about what we believe are significant, far-reaching and unnecessary changes to the accounting for property, plant and equipment (PP&E) that are now under discussion by the American Institute of Certified Public Accountants' (AICPA's) Accounting Standards Executive Committee (AcSEC). More specifically, we are concerned that AcSEC is promulgating GAAP standards that:

- are beyond the scope of the project's approved prospectus – which clearly stated that the project would not address depreciation;
- do not respond to the SEC's original concern about narrowing practice diversity – in fact, AcSEC's current conclusions will increase diversity;
- are beyond the scope of AcSEC's role of developing and issuing industry-specific or narrow GAAP guidance by implicitly prohibiting the use of the widely used composite method of accounting for PP&E and its depreciation;
- are beyond the limitations for completing the project established by the FASB at its February 26, 2003 meeting with AcSEC; and
- result in increased divergence from international standards with respect to "investment property."

After a careful review of AcSEC's draft and having observed AcSEC's discussions of the proposed Statement of Position (SOP), we believe that these shortcomings are particularly true with respect to the application of the proposed SOP's current conclusions concerning "investment property" as defined in IAS

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No. 40, *Investment Property*.[1] Investment property, also termed "income-producing real estate" is similarly defined in the Financial Accounting Standards Board's (the Board) now superseded SFAS No. 41, *Financial Reporting and Changing Prices: Specialized Assets – Income-Producing Real Estate.* AcSEC's conclusions do not exempt investment property from the proposed standards as IAS 16, *Property, Plant and Equipment* does. Further, IAS 40 establishes specific accounting for investment property that recognizes the unique economic characteristics of these properties.

We are communicating our concerns directly to the Board for two major reasons. First, we believe that AcSEC's current conclusions are inconsistent with the project's Board-approved prospectus and with the limitations placed on AcSEC for completing this project set by the Board at its February 26, 2003 meeting. Second, we have attended all public AcSEC discussions of the proposed rules and have not observed any discussion of our concern regarding the application of the proposed rules to investment property and the potential resulting conflicts with IAS 40.

As you know, NAREIT is the national trade association for real estate investment trusts (REITs) and other publicly traded real estate companies. NAREIT members include over 175 REITs and other companies that develop, own, operate, and finance investment property, as well as those firms and individuals who advise, study, and service these businesses. Providing useful and relevant financial information related to investment property is of vital importance to the capital and communications-related activities of companies involved in these businesses.

Our concern over the state of this project today is heightened because the Board has, for the past year, expressed its view that AcSEC should not promulgate generally accepted accounting principles (GAAP) except for limited scope transitional projects.[2] Our concern was echoed in Financial Executives International's (FEI) comment letter dated November 8, 2001 on the project's exposure draft. That comment letter stated, " . . .we have several general concerns about the proposed SOP. First, we do not believe AcSEC should be addressing such a broad topic. AcSEC has once again chosen to propose guidance affecting all companies under the guise of a limiting, yet misleading title . . . CCR (FEI's Committee on Corporate Reporting) strongly opposes the issuance of guidance on component accounting and believes it should be removed from the final pronouncement on PP&E." Further, the minutes of the Board's February 26, 2003 meeting clearly indicate that AcSEC would issue a final SOP covering PP&E, but

[1] IAS 40 defines investment property as follows: Investment property is held to earn rentals or for capital appreciation or both. Therefore, an investment property generates cash flows largely independently of the other assets of the enterprise. This distinguishes investment property from owner-occupied property. The production or supply of goods or services (or the use of property for administrative purposes) generates cash flows that are attributable not merely to property, but to other assets used in the production or supply process. IAS 16, *Property, Plant and Equipment*, applies to owner-occupied property.

[2] Your remarks at the Financial Executives International *Current Financial Reporting Issues Conference* on November 4, 2002 expressed this view.

limited to specific topics. **The list of topics to be addressed did not include depreciation or the componentization of PP&E.** Notwithstanding this direction from the Board, AcSEC continues to include depreciation and componentization of PP&E in its discussions regarding the proposed SOP.

We do not understand why the Board would want to allow AcSEC to promulgate significant and widely applicable standards at this time. We, therefore, respectfully request that the Board consider the proposed SOP in the context of its stated policy to limit the scope of AcSEC's work, its criteria for approving proposed AcSEC projects, the conclusions reached at the Board's February 26, 2003 meeting and the Board's commitment to the convergence of international accounting standards.

NAREIT staff and financial executives of its member companies have followed the development of this proposed SOP since it was initiated. This constituency has provided constructive input to AcSEC's project task force and to AcSEC through more than 35 comment letters. We would be pleased to make the NAREIT comment letter available to you.

In addition to our concerns regarding AcSEC promulgating universal GAAP that would result in widespread changes in practice and further divergence from international standards, we strongly disagree with certain AcSEC conclusions, including the following:

- the elimination of the composite method of depreciation – a significant universal change in practice under GAAP;
- the method of identifying PP&E components that would increase diversity in accounting for capital expenditures;
- certain limitations on the capitalization of costs, beyond allocations of general and administrative costs, some of which would create further divergence from international standards, and elimination of the current "lease-up accounting" standard applicable to property taxes and insurance; and
- applying many of the principles in this proposed SOP to investment property that would widen divergence with current international standards – actually moving the accounting for investment property in the U.S. in a direction opposite that of current trends in both U.S. and international standards.

These concerns are further discussed below.

<u>The Elimination of the Composite Method of Depreciation</u>

Current AcSEC conclusions regarding the accounting for PP&E costs would implicitly prohibit the use of the composite method of depreciation – a method widely used across corporate America. Further, the composite method of depreciation is supported by Accounting Research Bulletin No. 43 (ARB 43). After describing the allocation of costs, Chapter 9 of ARB 43: *Depreciation* states that "this procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage value (if any), over the estimated useful life of the unit *(which may be a group of assets)* in a systematic and rational manner" (*emphasis added*). Additionally, Government Accounting Standards Board Statement No. 34, *Accounting and Financial Reporting Alternatives,* allows the use of the composite method of depreciation.

The composite method of depreciation is also described in a number of textbooks, some of which are identified in Exhibit I to this letter. This method of depreciation does not require the write-off of the original cost and accumulated depreciation of assets or components replaced. The elimination of the composite method of depreciation from GAAP would force the componentization of trillions of dollars worth of PP&E, either at the date of adoption of the new standard or as components are replaced and their cost appropriately capitalized. The time and cost of componentizing all existing PP&E that is currently accounted for under the composite method in the accounts of corporate America could far exceed the benefits of this change in accounting principle. We, therefore, do not believe that the proposed rule meets the Board's clearance criteria that in a proposed AcSEC document "the benefits of the proposal are expected to exceed the cost of applying it."

Beyond AcSEC's prohibiting the composite method of deprecation, it is astounding to us that it would explicitly endorse the use of the "group life" or "mass asset" method of depreciation; another change to GAAP literature regarding depreciation that is not under AcSEC's delegated authority and that is inconsistent with the project's prospectus dated May 31, 2000. This prospectus states, "the project will also not address depreciation methods."

We have discussed the extent to which the composite method of accounting for PP&E is used in practice with financial executives in the real estate industry and audit practitioners both in the U.S. and in Europe. It is our understanding that the composite method of depreciation, at some level of PP&E grouping, is used by companies in many countries around the world, as well as by companies in the U. S. It seems inapropriate to us that AcSEC could eliminate a method of accounting for PP&E, and the depreciation of that PP&E, that is used around the world while explicitly endorsing a depreciation method that, to our knowledge, is only used by some specialized industries, *e.g*., railroads and utility companies. It is our view that AcSEC is reaching conclusions that would have far-reaching impacts on depreciation without focused consideration of current practice, implementation issues or the practical impacts of its conclusions. We urge the Board to evaluate the impact of the proposed SOP on actual accounting practice before approving the SOP.

We understand that AcSEC arrived at the elimination of the composite method of depreciation as a consequence of its inability to establish clear criteria for the capitalization of PP&E costs. In accordance with the project's prospectus, AcSEC initially attempted to define the kinds of costs that should be capitalized and/or criteria for capitalizing costs. Certain of the criteria discussed by AcSEC during the early stages of this project suggested that the costs related to PP&E could be capitalized if the cost represents PP&E activity that:

- extends the originally estimated useful life of the asset;
- increases the economic performance of the asset; or
- represents a betterment of the asset.

We believe that these criteria would have provided appropriate guidance for accounting for capital expenditures. However, because the criteria discussed by AcSEC did not provide bright-line rules for distinguishing those costs that could be capitalized, it concluded that the only clear rule would be to require that the cost of an item could only be capitalized if the item was a new PP&E component or replaced an existing component. This accounting requires that the costs and accumulated depreciation of replaced assets be accounted for separately – thus, the requirement for component depreciation.

We ask that the Board, in the context of its recently espoused intent to better control the proliferation of accounting standards, evaluate this conclusion to ensure that the resulting standard is operational, that its benefits outweigh the costs of implementing it and that it does not conflict with international practice. Based on our limited discussions with accountants familiar with accounting practice in Europe, in many cases the undepreciated cost of replaced PP&E components is not written off and, at the same time, the cost of the replacement component is capitalized, *i.e.*, the composite method of accounting for PP&E. This is clearly true with respect to accounting for investment property that is carried at fair value in accordance with IAS 40.

Impact on the depreciation of investment property:

The composite method of depreciation is used extensively to measure depreciation for investment property. This accounting method, as applied to investment property, should not be eliminated unless standard setters are first prepared to consider alternative methods of depreciation that may more appropriately reflect the cost recovery pattern of investment property.

In 1981, AcSEC approved an Issues Paper *Depreciation of Income Producing Real Estate* and sent it to the Board for consideration. The Paper suggested that the sinking fund method of depreciation would more appropriately reflect the cost recovery pattern of investment property. The Board declined to consider this Issues Paper and indicated that it would consider the Paper in the context of a broader project covering depreciation if and when such a project was put on the Board's agenda.

In 1996, NAREIT and the National Association of Real Estate Companies discussed a depreciation methodology labeled "salvage value depreciation" with Mr. Timothy Lucas, the Board's Director of Research and Technical Activities at that time. Mr. Lucas indicated that the proposal had merit and should be sent to the EITF for consideration. At the same time, he suggested that we discuss the proposal with Mr. Michael Sutton, the then SEC's Chief Accountant, to determine that he had no objection to the EITF putting the proposal on the EITF's agenda. After discussion with Mr. Sutton's staff, we were told that he did not favor considering the proposal at that time.

Both of these proposals would provide an alternative method of depreciation of investment property within the historical cost framework. The 1981 proposal was developed by AcSEC's Real Estate Accounting Committee and approved by AcSEC. The 1996 proposal was thoroughly considered by industry financial managers, company executives, investors, analysts and representatives of major auditing firms.

The proposed SOP's component method of accounting for PP&E and depreciating that PP&E would require extensive administrative effort that would not result in an improvement in depreciation accounting for investment property.

We are exceedingly disappointed that the depreciation of investment property would be significantly impacted by the proposed SOP as an indirect result of AcSEC's process when two serious alternative approaches were not even considered by the Board.

If the Board approves AcSEC's proposed elimination of the composite method of accounting for PP&E, we request that the Board exempt investment property from the componentization requirements of the proposed SOP until it has the opportunity to directly address depreciation accounting for this property.

The Proposed SOP Would Increase the Diversity in Accounting for Capital Expenditures

The original concern expressed by the SEC in the correspondence initiating this project was that there is wide diversity in practice in the accounting for capital expenditures related to real estate subsequent to initial development or acquisition. However, we strongly believe that the proposed SOP would increase diversity rather than decrease it. AcSEC's current conclusions, as we understand them, would allow the management of each company to define the level of componentization of its PP&E. Unless a company subsequently changed its level of componentization, the cost of any replacement of a part within a component would be expensed. It seems clear to us that this conclusion would create significant diversity in the level of componentization between companies for similar PP&E and, therefore, significant diversity in the reported expense of replacing parts of defined components.

For example, the level of componentization of an office building could range from one component to hundreds of components – or any number in between. A company choosing to identify the entire building as one component would expense the cost of replacing any part of the building. Another company could choose to identify 200 components for the same type of office building. This company would be able to capitalize the costs of replacing the 200 components.

We request that the Board evaluate the proposed rules to ensure that they would not increase the diversity of accounting for capital expenditures.

The Proposed SOP Would Place Inappropriate Limitations on the Capitalization of Costs – Some That Conflict with International Standards

The proposed SOP would significantly limit the capitalization of costs of PP&E when compared with current practice under GAAP. While we agree that it would be appropriate to restrict certain current capitalization practices, we believe that many of the limitations reflected in AcSEC's current conclusions go well beyond the initial basis for the project, result in inappropriate financial reporting and conflict with international standards. Following are examples of limitations that we believe are inappropriate:

- The proposed SOP would allow the capitalization of only payroll and benefit costs of internal (company) employees that are directly associated with the development/construction of PP&E. Why would all direct costs of these employees not be capitalizable – their equipment costs, supplies, utilities and applicable space costs?
- The cost of paid time off (holidays, vacation, sick time, etc.) would not be capitalizable under the proposal – in spite of the explicit provision in the proposed SOP that benefit costs may be capitalized.
- Rental costs of land and/or buildings would not be capitalized under the proposal. This limitation seems completely inconsistent with the capitalization of other carrying costs (interest, property taxes and insurance) during the development of PP&E.
- The cost of planned major maintenance may not be capitalized under the proposal. This would change current practice, which is consistent with international standards and, therefore, would create further divergence among global standards.
- The proposed SOP would prohibit the capitalization of the removal costs incurred to replace a PP&E component. Paragraph 20A of IAS 16 allows for the capitalization of costs related to "removing the asset."

We request that the Board critically review AcSEC's conclusions to ensure that they are internally consistent and would not create further divergence from international standards.

Elimination of "lease-up accounting" for carrying costs during the development of real estate:

The Board's Statement of Financial Accounting Standards No. 67 provides for the allocation of carrying costs between portions of a real estate project that is occupied and generating rent and portions that are not occupied and, in many cases, are being improved for a specific tenant. To guard against any possible abuse of this guidance, the allocation of costs may not be continued for more than one year after the first tenant occupies the project. The industry has used this principle for over 30 years. The purpose is to report operating results during the lease-up period of large real estate projects that provide a more realistic indicator of the property's earnings potential.

We ask that the Board consider maintaining the current lease-up accounting principle to allow the real estate industry to provide useful earnings reporting during the lease-up of major real estate projects.

<u>Applying the Proposed SOP to Investment Property Conflicts with International Accounting Standard No. 40, *Investment Property*</u>

It is clear that the Board, as well as the SEC and standard setters around the world, supports the development of high quality international accounting standards to facilitate cross-border capital flows. AcSEC has compared the guidance in the proposed SOP with IAS 16, as amended by the improvements project. Even after this comparison, AcSEC does not intend to exempt investment property from the proposed rules as IAS 16 exempts investment property from its standards except during the construction stage of the property. Applying the proposed PP&E standard to investment property would create further divergence with the international standard. IAS 40 requires disclosure of the fair value of investment property either in the financial statements or in accompanying notes and sets forth standards for accounting for subsequent expenditures. Where investment property is carried at fair value in the balance sheet, these expenditures are not accounted for as prescribed by IAS 16 but are added to the aggregate cost of a property.

The economics of owning and operating investment property are far different than the economics related to PP&E used to provide goods and services. These economic characteristics have been recognized by the FASB in previous standard setting, *e.g*., Statements of Financial Accounting Standard Nos. 41 and 67; and IAS 40 recognizes the economic characteristics of investment property. The componentization required by the proposed SOP is inconsistent with the integrated-operating-entity concept underlying the standards of accounting for investment property contained in IAS 40. Measuring the fair value of investment property requires that the property be viewed as an integrated operating entity, a package of service potential – not as an amalgamation of hundreds of components. As AcSEC has debated the proposed standards over the past two years, a number of members have commented that the componentization requirements of the standard would not be necessary in the framework of fair value reporting. We agree with this interpretation.

Certainly, as accounting standards converge globally, there is a real possibility that investment property would be accounted for consistent with IAS 40. Coincidently, we understand that AcSEC is currently considering how a proposed SOP, that will clarify the scope of the *Audit and Accounting Guide Audits of Investment Companies,* might apply to direct investments in real estate. To require owners/operators of investment property to dramatically move in a direction counter to the more far-reaching direction of international accounting standards is inappropriate, unnecessary and inconsistent with the FASB's and SEC's commitment to achieving international convergence of high quality accounting standards. We believe that changing U.S. GAAP to require componentization of investment property and setting new standards for accounting for capital expenditures related to investment property that are inconsistent with the corresponding international standards, would likely result in the real estate industry's financial reporting and accounting systems being whipsawed as accounting standards move toward global convergence.

In summary, we request that the Board:

- limit the guidance in the final SOP consistent with the project's prospectus and the Board's conclusions from its February 26, 2003 meeting. Specifically, the Board should eliminate any explicit or implicit changes to current GAAP depreciation standards from the final SOP;
- recognize the characteristics of investment property and avoid approving aspects of the proposed SOP that would create greater divergence with the distinct international standards applicable to investment properties. Specifically, if the final SOP eliminates the composite method of accounting for PP&E, it should exempt investment property

from the proposed SOP's componentization requirements. It makes no sense to require componentization of investment property when, within the foreseeable future, this property might be accounted for as a single economic unit and capital expenditures accounted for as provided in IAS 40;

- continue to allow the use of the composite method of depreciation for investment property until standard setters are prepared to consider methods of depreciation that more appropriately reflect the cost recovery pattern of this property;
- consider the limitations on the capitalization of costs against internal consistency within the proposed SOP and against international practice; and
- maintain the current lease-up accounting principle.

Regardless of the Board's conclusions with respect to this AcSEC project, the proposed SOP should be re-exposed. There has been no public exposure of AcSEC's conclusions for two years. During this time, AcSEC has discussed the comment letters and has revised a number of important conclusions. Because the proposed SOP would have a significant impact on our industry, we have attended all public AcSEC discussions of this project. The great majority of constituents who commented on the proposed SOP have not had the benefit of observing these discussions. Further, we have talked to some constituents who believe that the project cannot address universal standards and, therefore, these constituents have not focused on AcSEC's continued work this project.

We would appreciate the opportunity to discuss our views on the proposed SOP with the Board and will call you to schedule a meeting.

Respectfully submitted,

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Attachments

Exhibit I

References To The Composite Method Of Depreciation

The proposed SOP implicitly eliminates the composite or group method of depreciation as it is defined in a number of references (listed below) and as it is widely applied in practice. The specific issue is the accounting for replacements. Many companies use the composite/group method of depreciation for major portions of an investment property and do not recognize gains and losses on retirement of components within the major categories.

Under the proposed SOP, the original cost and accumulated depreciation of a replaced component would be estimated and any remaining net book value would be recorded as an expense. Requiring such recognition would result in a significant change in practice and represent a clear inconsistency with the widely accepted definition of the composite method of depreciation which is also discussed in the following textbooks:

- *Accounting Principles*; Fess & Warren; Seventeenth Edition, 1993, page 389.
- *Intermediate Accounting*; Keiso and Weygandt; Seventh Edition, 1992, pages 550 – 552.
- *Intermediate Accounting;* Welsch and Zlatkovch; Eighth Edition, 1989, pages 490 – 493.
- *Intermediate Accounting*; Smith & Skousen; Eighth Edition, 1984, pages 396 – 398.
- *Intermediate Accounting*; Meigs, Johnson and Keller; McGraw Hill, 1963, pages 556 – 557.

Specifically, all of these references indicate that no recognition of gain or loss is required under the composite method of depreciation upon retirement/replacement of a component.