NAREIT National Policy Bulletin

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Real Estate Companies Implement Segment Disclosures

For a majority of NAREIT Corporate members, fiscal year 1998 will be the first reporting period in which disclosures about business segments (FASB Statement No. 131) will be included as a footnote. To help publicly traded real estate companies implement Statement No. 131, in recent weeks NAREIT spoke with a number of financial executives to learn how they established operating and reporting segments, what performance measurements they plan to use, as well as other related items concerning segment disclosures. From these discussions, NAREIT made the following observations.

Segments by Property Type
The Statement requires companies to disclose segment information based on how management makes business decisions. For real estate companies, decision making is typically based on property data. For this reason, the number and type of operating segments that companies plan to report is dependent on the different types of properties in which each company is involved. Absent foreign operations, property type was the overriding criteria used, with no regard to geography.

Multiple Property-Type Companies
All companies surveyed with more than one property type plan to aggregate segment information on the basis of property type, such as office, industrial, retail, and apartments. Other segments may include land sales, development, service operations, and corporate/other for unallocated items.

Single Property-Type Companies
The basis for aggregation by single property-type companies surveyed can best be characterized as "revenue type." A majority of single-sector companies plan to disclose information on at least two segments, with one segment representing rental real estate operations. The other segments may include service operations, a preferred-stock subsidiary, or corporate/other for unallocated items.

One apartment REIT executive told us that the company plans to further segment its rental real estate operations by status of the property to include: segments for fully stabilized properties, properties stabilized at the beginning of the year, properties in lease up, disposed properties, and acquired properties.

NAREIT survey Findings on FASB Statement No. 131:

- Real estate companies are making decisions based on property data.
- Companies with more than one property type plan to aggregate segment information on the basis of property type, such as office, industrial, retail, and apartments.
- The basis for aggregation by single property-type companies can best be characterized as "revenue type."
- Most companies plan to report real estate revenues and expenses, related depreciation and amortization, capital investment, and total assets for each property segment.

Many executives plan to report either "segment contribution to FFO" or "segment net operating income" as a measurement of profit or loss.

Another executive said that his shopping center REIT will use segments for its properties, preferred-stock subsidiary, and corporate/other, basing its choices on how it assesses performance and compensates employees.

A hotel REIT executive indicated that their segments will be by lessee, consistent with their internal reporting, in addition to a segment for corporate and unallocated items. Another hotel REIT with one lessee plans to report one segment for hotels and a second for corporate and other.

Mortgage REITs
Two different mortgage REIT executives reported alternative approaches for segments: one indicated that

management looked at mortgage loans as the only reporting segment; another mortgage REIT said that they look at three segments-loan investments, investments in CMBS, and investments in real estate. For each segment, the mortgage REITs plan to report revenue, profit, assets and reconciliations.

Information Presented
Most companies plan to report real estate revenues and expenses, related depreciation and amortization, capital investment, and total assets for each property segment. Interest expense, G&A, and other reconciling items would fall under a segment labeled "corporate" or "other," unless specifically identifiable to the segment. The Statement requires entities to report a measure of profit or loss and total assets for each reportable segment. Additional information is required if it is included in the measure of segment profit or loss reviewed in the decision-making process. If more than one measure is used in the decision-making process, the Statement requires that the reported measures be those that are most consistent with those used in the consolidated financial statements (i.e., closest measures to generally accepted accounting principles (GAAP)).

Statement No. 131 emphasizes disclosure of a performance measurement. Notably, the Securities and Exchange Commission (SEC) has confirmed to NAREIT that the measurement of profit or loss does not have to be in conformance with GAAP, but must be a measure used when making decisions about allocating resources to the segment and assessing its performance. However, a reconciliation to income before income taxes, extraordinary items, discontinued operations, and the cumulative effect of changes in accounting principles, as reported in the consolidated financial statements, must also be presented.

REITs Plan to Report FFO
Many executives told us that they plan to report either "segment contribution to FFO" or "segment net operating income" as a measurement of profit or loss. This generally consists of "real estate revenues" less "real estate expenses". REIT executives indicated that this is the information their company uses to assess the performance of an individual property and/or property segment, and make operating decisions.

Those companies that indicated they would not use FFO as a measure of profit or loss primarily based their decision on the belief that the SEC would not allow FFO in the disclosure. To address this misconception, we have included the following response from the SEC to NAREIT, dated February 6, 1998, regarding the use of FFO within the operating segment disclosures required by Statement No. 131:

To the extent that the chief operating decision maker of any entity uses funds from operations or other derivation, other than net income before income taxes and other items as determined under generally accepted accounting principles (GAAP), as a performance measure, that entity may present such information within its operating segment disclosures. However, in such circumstances, the provisions of Statement 131 require that a reconciliation to net income before income taxes and other items also be provided. Furthermore, the amount of depreciation, depletion, and amortization, should be separately shown for each reportable segment.

Analyst Comments
Analysts expect the segment information presented to be useful in assessing company/segment performance, as well as evaluating management's decision-making and competency. Notably, the segment disclosure requirement is the first opportunity for financial statement users to examine information specifically identified as being used by management to make decisions. Moreover, one analyst observed: "If REITs do not include FFO in the footnote, whether it be on a segment or enterprise-wide basis, it is an indication that management does not consider it as a performance measurement. This raises questions about why they present it to investors, but do not use it themselves."

By requiring segment disclosures, analysts also expect the quality of financial information to be improved. This is especially relevant to FFO when it is included as a segment disclosure - for the first time it will be subject to "review" by auditors.

Auditor Comments
Auditors indicated that the inclusion of FFO in the footnote would provide the opportunity to "review" FFO in connection with the NAREIT definition and White Paper during the course of the audit.

As expected, companies are adopting the reporting standard as it was intended -- reporting segments by property type. This is consistent with the way they report internally and make decisions.

Competitive Harm
None of the executives surveyed were concerned about the potential for competitive harm at the level of disclosure required by the Statement. In fact, many companies have been reporting the segment information in some manner, either in the form of an earnings press release or SEC filing. Most felt that aggregated information would not pose a competitive threat. However, several indicated that if they had to disclose individual-property information, it could potentially be detrimental from a competitive standpoint.

Usefulness of Standard
Most respondents felt the Standard would be helpful to users of financial statements, but that its usefulness is mitigated by the fact that a majority of the information to be presented is typically already available through earnings press releases or supplemental information.

Consistency in Reported Information
The segment information presented under the Statement and found in earnings press releases generally will be the same, but the data in the press release may be more or less detailed and presented in a narrative or tabular format.

The Statement requires consistency between the information presented as segment disclosures in the financial statement footnotes and information in the MD&A. Accordingly, all of the executives we spoke with said that the information in the footnote and the management discussion would be consistent. SEC officials also have specifically addressed the importance of consistent reporting throughout financial filings.

Enterprise-Wide Disclosures
The Statement also requires companies to disclose enterprise-wide information on a geographic basis if there are foreign operations. This includes revenues and long-lived assets attributed to the country of domicile, as well as each foreign country, if material.

An additional disclosure is required for major customers if revenues are equal to or greater than 10 percent of total revenues.

Presentation Format for Real Estate Companies
The examples are based on the formats REITs shared with us. Virtually all of the companies surveyed will be reporting the segment line item information on a GAAP basis, with the measurement of segment profit or loss reconciled to income before income taxes, extraordinary items, discontinued operations, and the cumulative effect of changes in accounting principles.

Multiple Property-Type REITs

199X	Office	Industrial	Retail	Apartments	Corporate/ Other/1	Consolidated
Real estate revenues	$ xx,xxx	$ xx,xxx	$ xx,xxx	$ xx,xxx	$ xx,xxx	$ xx,xxx
Real estate expenses	(xx,xxx)	(xx,xxx)	(xx,xxx)	(xx,xxx)	(xx,xxx)	(xx,xxx)

Operating income	xx,xxx	xx,xxx	xx,xxx	xx,xxx	xx,xxx	xx,xxx
Interest expense					(xx,xxx)	(xx,xxx)
General & administrative					(xx,xxx)	(xx,xxx)
Funds from operations	xx,xxx	xx,xxx	xx,xxx	xx,xxx	(xx,xxx)	xx,xxx
Depreciation & Amortization	(xx,xxx)	(xx,xxx)	(xx,xxx)	(xx,xxx)	(xx,xxx)	(xx,xxx)
Other reconciling items (+/-)	xx,xxx	xx,xxx	xx,xxx	xx,xxx	xx,xxx	xx,xxx
Net Income	$ xx,xxx	$ xx,xxx	$ xx,xxx	$ xx,xxx	$ xx,xxx	$ xx,xxx
Capital Investment/2	$ xx,xxx	$ xx,xxx	$ xx,xxx	$ xx,xxx	$ xx,xxx	$ xx,xxx
Total Assets	$ xx,xxx	$ xx,xxx	$ xx,xxx	$ xx,xxx	$ xx,xxx	$ xx,xxx

Single Property-Type REITs

199X	Rental Real Estate	Service Operations	Corporate/ Other/1	Consolidated
Real estate revenues	$ xx,xxx	$ xx,xxx	$ xx,xxx	$ xx,xxx
Real estate expenses	(xx,xxx)	(xx,xxx)	(xx,xxx)	(xx,xxx)
Operating income	xx,xxx	xx,xxx	xx,xxx	xx,xxx
Interest expense			(xx,xxx)	(xx,xxx)
General & administrative			(xx,xxx)	(xx,xxx)
Funds from operations	xx,xxx	xx,xxx	(xx,xxx)	xx,xxx
Depreciation & Amortization	(xx,xxx)	(xx,xxx)	(xx,xxx)	(xx,xxx)
Other reconciling items (+/-)	xx,xxx	xx,xxx	xx,xxx	xx,xxx
Net Income	$ xx,xxx	$ xx,xxx	$ xx,xxx	$ xx,xxx
Capital investment/2	$ xx,xxx	$ xx,xxx	$ xx,xxx	$ xx,xxx
Total Assets	$ xx,xxx	$ xx,xxx	$ xx,xxx	$ xx,xxx

/1 - Unallocated items such as debt charges, general and administrative, as well as small segments that do not meet the threshold requirements of the Statement as a reportable segment.

/2 - Property acquisitions and capital improvements.

Questions on Segment Disclosures should be directed to, Marti Tirinnanzi, Director of Financial Standards, at (202) 739-9438, or David Taube, Financial Standards Analyst, at (202) 739-9442.