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# EITF Reverses Accounting on Contingent Rents

### SEC Expresses Reservations

On November 19, 1998, the Emerging Issues Task Force of the Financial Accounting Standards Board withdrew its May 21, 1998 consensus on EITF Issue No. 98-9, Accounting for Contingent Rents in Interim Periods. The decision effectively reverses the problematic accounting for contingent rents that applied to this year's second and third quarter reports. REITs can now revert to the accrual of percentage rents practice that was in place earlier this year, before EITF 98-9 was announced.

The change in thinking for the EITF represents a victory for NAREIT, which coordinated the communications campaign to the EITF, thereby providing the needed information to substantiate the EITF's current thinking on Issue 98-9 and its ultimate withdrawal. Percentage rent comprises a substantial portion of income for hotel REITs and also may be significant to retail and healthcare REIT earnings. Without including percentage rents in interim reports, earnings releases for those REITs that charge percentage rent were distorted, causing unnecessary concern among investors unfamiliar with the change in accounting.

During the time that the industry worked towards changing the EITF=s thinking on contingent rents, REITs reported an adjusted FFO that included and disclosed deferred income on percentage rents as though EITF 98-9 was not in effect. Investors and analysts, who also strongly disapproved of EITF Issue 98-9, supported this disclosure practice.

**Transition Guidance**
The only official accounting guidance about the withdrawal of Issue No. 98-9 may be found in the EITF Minutes for the November 18 and 19, 1998 meeting. Going forward, companies should adopt the same accounting practice for percentage rents that they applied prior to EITF 98-9. The EITF minutes for the meeting will recommend specifically that the practice that was in place as of year-end 1997 should remain in place. Companies may choose to restate second and third quarter 1998 results for comparative purposes.

The EITF also decided that those REITs that had not accrued contingent rents prior to EITF 98-9 should not change their practice. By withdrawing the decision, the EITF has not interpreted generally accepted accounting principles for the treatment of contingent rents.

**SEC Policy Implications**
The change in thinking by the EITF was met with strong objections from the Securities and Exchange Commission staff. The SEC accounting staff had supported the 98-9 practice on the basis that income should not be accrued if it can be reversed.

From the SEC's perspective, the issue with accruing percentage rent is when lease terms require tenants to reach annual sales or revenue targets. The possibility exists, however remote, that if the target is not met the lessor forfeits percentage rent. The SEC takes exception to prior earning reports that are, after the fact, misleading as the percentage rent accrued in prior periods would have to be reversed.

**SEC Accounting Bulletin on Revenue Recognition**
Following the EITF's decision to withdraw its consensus, Chief Accountant Lynn Turner indicated that the SEC intends to pursue this matter and that percentage rents would likely be addressed following the expected December 1998 release of the SEC's Staff Accounting Bulletin (SAB) on revenue recognition. Heightened interest by the SEC staff on accounting for contingent rent is due to a new policy initiative underway at the SEC to improve the quality of financial reporting. The project is expected to produce better guidance and vigilant enforcement on matters related primarily to earnings management.

Even though industry letters sent to the EITF were sufficiently persuasive for the accounting on contingent rents to be withdrawn, the SEC staff has yet to be convinced that the circumstances in which percentage rents are earned, gauged and paid should be accrued when lease terms require reversing percentage rent when specified benchmarks are not achieved. As a practical matter, REITs that are renewing lease contracts should consider restructuring percentage rent provisions to avoid potential earnings recognition problems in the future.

**REIT Response**

Some REITs are thinking about either charging percentage rent as a percentage of all sales and thereby eliminating any benchmark, or alternatively, establishing quarterly sales benchmarks that might be achievable and confirmed each quarter and are not contingent on meeting a threshold beyond the quarterly period.

When percentage rent terms are restructured, auditors and others familiar with the idiosyncrasies of lease accounting should be involved. For example, if contingent rents have characteristics of minimum lease payments, amounting to at least 90% of the fair value of the property, a possibility exists that the transaction would be subject to financing lease accounting instead of operating lease accounting C also suggesting that a transfer of ownership has taken place.

Questions on EITF 98-9 should be directed to NAREIT's Director of Financial Standards, Marti Tirinnanzi at (202) 739-9438.