NAREIT

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AcSEC: One ED Issued, One ED On Deck

Joint Ventures Exposure Draft Issued

In the works since 1991, the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) in November 2000 released an Exposure Draft (ED) of its proposed Statement of Position (SOP), *Accounting for Investors' Interests in Unconsolidated Real Estate Investments.* The SOP would clarify and expand SOP 78-9, *Accounting for Investments in Real Estate Ventures.*

Under the proposal, the equity method of accounting would be used when an investor has significant influence in an unconsolidated real estate investment (the "Venture"). However, in applying the equity method, rather than using an income statement approach that considers a share of the Venture's net income to calculate the impact on the investor's earnings/loss, the investor would be required to use a "claim on net assets approach." This approach, labeled Hypothetical Liquidation at Book Value (HLBV), is a complex, balance-sheet oriented approach that considers the Venture's capital structure. Except in certain circumstances, the "book value" would be calculated on an historical cost basis – not fair value. Using the HLBV approach, the investor would calculate its claim as the amount it would receive (or be obligated to pay) if the Venture liquidated all of its assets at recorded amounts based on generally accepted accounting principles (GAAP) and distributed the resulting cash to creditors and investors based on their respective priorities. The investor would report in its earnings the change in its claim from the beginning to the end of a period.

The proposed SOP provides an earnings recognition model for when an investor owns multiple types of interests in a Venture (i.e., common stock, preferred stock, and debt) and guidance for situations when an investor's capital account has a deficit balance or the Venture has a negative net worth. Generally, the investor must record its share of losses of the Venture beyond its investment to the extent it has guaranteed obligations of the Venture, is otherwise committed to provide further financial support for the Venture, or if the imminent return to profitable operations by the Venture appears to be assured. The SOP also, in certain circumstances, extends the equity method to an investor in nonvoting common stock and nonredeemable preferred stock in a Venture and provides rules for Ventures that are organized as "specific ownership account" structures (i.e., general partnerships, limited partnerships, limited liability corporations, and limited liability partnerships). Other areas in which guidance is provided include calculation of basis differences and accounting for the sale of a joint venture interest. Due to the complexity of the concepts, the SOP contains numerous illustrative examples.

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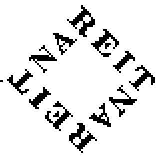


The deadline to comment on the Exposure Draft is April 15, 2001. The proposal would apply to financial statements issued for fiscal years beginning after December 15, 2001. Any earnings impact from the new standard as of the date of adoption would be recorded as a cumulative effect from a change in accounting principle. NAREIT's Joint Ventures Task Force plans to prepare an industry comment letter. Anyone not on the Task Force who is interested in participating should contact David Taube at dtaube@nareit.com or (202) 739-9442.

Status of Cost Capitalization Project

The AICPA staff is currently in the process of finalizing a draft of its SOP, *Accounting for Certain Costs and Activities Related to Property, Plant and Equipment*, so that it can be submitted to the Financial Accounting Standards Board (FASB) to obtain clearance as an ED. Assuming the FASB provides clearance, an ED of the SOP is anticipated to be issued for public comment early in the second quarter of 2001, with a final standard effective for 2002. The SOP will include capitalization accounting guidance for property, plant and equipment (PP&E) for all industries, as well as the accounting for costs related to major repairs and maintenance expenditures (in some industries known as overhauls and turnaround costs).

Because the SOP will impact the accounting for PP&E in all industries, NAREIT has been contacting other industry groups to brief them on the proposal and solicit their support of our positions on this proposal. To date, we have discussed, or plan to discuss, the proposal with the Edison Electric Institute (electric utilities), the Financial Executives Institute, the Association for Financial Professionals, the Association for Investment Management and Research, the Equipment Leasing Association, the Alliance of Automobile Manufacturers, the Air Transport Association of America, representatives of the defense industry, the Iron and Steel Institute, the American Association of Railroads, the National Association of Manufacturers, the Business Roundtable, and the U.S. Chamber of Commerce.

With the proposal's potential negative impact on the net income and FFO of real estate companies, NAREIT will be requesting that each member company develop a response and share its and NAREIT's views on the ED with its audit firm. To assist companies in this effort, NAREIT's Cost Capitalization Task Force plans to complete and distribute a comment letter shortly after the issuance of a public ED. NAREIT's task force and staff will be prepared to help companies identify the issues to be addressed in a comment letter.

Update on FASB Activities

NAREIT Participates in Asset Impairment Roundtable

The FASB invited NAREIT to join 14 other participants in a discussion of the FASB's Exposure Draft, *Accounting for the Impairment or Disposal of Long-Lived Assets and for Obligations Associated with Disposal Activities.* On January 16, George Yungmann, NAREIT's Vice President, Financial Standards, participated in the roundtable discussion with FASB Board members and representatives from General Electric, Citigroup, the Edison Electric Institute, and the major audit firms. This invitation is recognition of the quality of the comments developed by NAREIT's Accounting Committee Task Forces. Participating in this roundtable discussion provided NAREIT an opportunity to explain its views on the Exposure Draft, as well as enhance its relationship with the primary standard setter of GAAP.

In July 2000, the FASB issued an ED of the asset impairment and disposal proposal. The proposal would supersede FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (issued in March 1995), and would be effective, generally on a prospective basis, for all periods in financial statements issued for fiscal years beginning after December 15, 2001. A comment letter prepared by NAREIT's Task Force can be found under Accounting Issues in the Members Only section of www.nareit.com.

Consolidations Project Temporarily Tabled
In January 2001, the FASB decided to temporarily table its consolidations project that would provide guidance on when affiliates should be included in a company's financial statements. Citing insufficient Board member support, the FASB will consider its future plans for the project in the third quarter of 2001 after two new Board members are in place. A supermajority of five of the seven members would have been required to issue a final standard.

Questions about the operationality of the new control-based notion for normal operating entities and other technical aspects of the proposal led the FASB to table this project. These and other issues will be revisited when the FASB reconsiders the project later this year.

Business Combinations: Pooling Ended - Goodwill Impairment Testing
In a unanimous vote, the FASB has tentatively decided to elminate the pooling-of-interests method of accounting for business combinations. This would result in all business combinations being accounted for using the purchase method subsequent to the issuance of a final standard - expected in June 2001. The decision to eliminate the pooling method follows the FASB's December conclusion to adopt an impairment-only approach for the amortization of goodwill. December's decision could eventually have significance on how the real estate industry reports depreciation of investment property.

The decision to no longer require the amortization of goodwill represents a significant change to the stance in the December 1999 business combinations ED, which would have required purchased goodwill to be amortized over no longer than 20 years. Under the impairment-only approach to be outlined in a new standard, goodwill would be reviewed for impairment at the lowest reporting level that includes the acquired business (the reporting unit). A company would be required to determine the value of the reporting unit and the value of the recognized net assets (excluding goodwill) of the same unit. The difference between those amounts (i.e., the implied value of goodwill) would be compared with the carrying amount of goodwill related to that unit to determine if an impairment loss should be charged against earnings.

To provide for future impairment reviews, a benchmark assessment would be performed within one year of the acquisition date if the amount of goodwill were significant to the reporting unit. Subsequent impairment reviews only would be required upon the occurrence of events indicating that goodwill of the reporting unit might be impaired. As part of its guidance, the FASB will provide examples of events and circumstances that would require goodwill of a reporting unit to be reviewed for impairment.

Also noteworthy is the related decision to cease the amortization of goodwill arising from acquisitions completed before the effective date of the new standard. Pre-existing goodwill also would be subject to the foregoing impairment review. Goodwill would be presented as a separate line item in the balance sheet and goodwill impairment charges would be presented as a separate line item in the operating section of the income statement unless the goodwill impairment loss is associated with a disposition or a discontinued operation.

The FASB plans to issue in February 2001 an ED on its tentative decisions related to the accounting for goodwill. NAREIT's Business Combinations Task Force will consider commenting on the proposed changes.

In a related aspect to the business combinations proposal, the FASB also has tentatively changed its position for the amortization of intangible assets that are recorded separately from goodwill. An intangible asset would be recognized separately from goodwill if it meets either of the following criteria: (1) control over the future economic benefits of the asset is obtained through contractual or other legal rights; or (2) the asset is capable of being separated or divided and sold, transferred, rented, or exchanged.

Instead of a presumption that an identifiable intangible asset has a useful economic life of 20 years or less, the FASB has concluded that an acquired intangible asset should be amortized over its useful economic life and reviewed for impairment in accordance with FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.* Acquired intangible assets with an indefinite useful economic life would not be amortized until its life is determined to be finite. As with goodwill, intangible assets that are not amortized would be tested for impairment whenever an event occurs indicating that the asset may be impaired, in accordance with Statement 121. These provisions also would apply to intangible assets with indefinite lives that exist prior to the issuance of a final standard.

The Board also has revised and expanded the list of separately identifiable intangible assets that will be included in the final guidance. This is an attempt to reduce the size of purchased goodwill and make financial statement information about intangible assets more useful.

A final standard that will incorporate the FASB's decisions on the pooling method and the accounting for goodwill and other purchased intangible assets is expected in June 2001. The provisions related to the accounting for purchased goodwill and other intangible assets would apply to goodwill and intangible assets arising from acquisitions completed both before and after the issuance date of the final standard, and would be effective for interim and annual financial reporting periods beginning after the final standard is issued.

NAREIT Derivatives and Hedging Task Force Issues Bulletin

In November 2000, NAREIT staff and the Association's Derivatives and Hedging Task Force distributed to members a National Policy Bulletin entitled "Interest Rate Risk Management Policy: Framework for Policies and Internal Controls Governing Interest Rate Risk Management for Real Estate Companies." The Bulletin was prepared to assist companies develop policy statements outlining their objectives and strategies for using derivative instruments before the new derivatives accounting standard (SFAS No. 133, *Accounting for Certain Derivative Instruments and Certain Hedging Activities, as amended by SFAS No. 138)* took effect on January 1, 2001. The Bulletin is intended to serve as a resource by providing guidance for the development of a formal company policy required by the standard. The policy would document internal controls that would lead to the achievement of the intended levels of hedge effectiveness through an increased understanding of the derivative instruments utilized.

The Bulletin can be found under Accounting Issues in the Members Only section of www.nareit.com. NAREIT wishes to thank the task force and its chair, Marti Tirinnanzi (Chatham Financial), for their assistance in developing the Bulletin.

Joint Ventures: Business Combinations Phase II

The FASB continued to deliberate issues on its project, called "Business Combinations Phase II," that would require the carrying amounts of all, or most, of the assets and liabilities in a combination or shared operation to be recorded at current values. This could have a considerable impact on accounting for real estate joint ventures. Significant tentative conclusions in the project related to new basis issues include:

- a change in control over the net assets from unilateral control to joint or shared control should result in a new basis of accounting for those net assets in the financial statements of the joint venture at its formation, and
- an entity that exchanges appreciated or previously unrecognized assets for an equity interest in a joint venture should recognize a gain on the assets exchanged.

Meanwhile, the FASB's EITF also is considering joint venture accounting. In Issue 98-4, *Accounting by a Joint Venture for Businesses Received at Its Formation*, the EITF has reactivated its consideration of what characteristics would require the newly-

formed entity to use the predecessor's basis or current value to account for contributed assets and liabilities. In its review of this issue, the EITF assumes that the newly formed entity is a "corporate joint venture" formed by issuing equity securities to two or more unrelated enterprises in exchange for subsidiaries or divisions of the venturers that are businesses. The issue focuses on how the joint venture should record, in its separate financial statements, the businesses received at its formation. Current practice generally has been to report the assets that a business contributes to a joint venture at historical cost unless certain conditions are met. Transactions that are considered business combinations require acquisition/current value accounting. Conclusions reached in this project would provide interim guidance pending the outcome of the above FASB Business Combinations Phase II project.

EITF Provides Guidance on Stock Compensation

Subsequent to the FASB's March 2000 issuance of Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, its interpretation of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, in June 2000 the Securities and Exchange Commission (SEC) delivered to the FASB 30 practice issues and questions on accounting for stock compensation. An EITF working group was formed to consider these items, now contained in EITF Issue No. 00-23. Through November 2000, the EITF had reached final consensus on 21 of the issues identified. Many of the issues are complex and narrow, but some may be of particular interest to NAREIT members – including accounting for the following:

- Exchange of Stock Options Other Than in an Equity Restructuring
- Indirect Guarantees of the Value of Stock Option Grants
- Stock Options with Fair Value Repurchase Features
- Fixed Stock Awards with Pro Rata Vesting
- Changes to Stock Option Terms in a Purchase Business Combination (several issues)
- Modification of Terms of a Stock Option Award in Connection with a Change in the Grantee's Employment Status (several issues)
- Options Granted to Employees of Entities Under Common Control

Further information about these issues is available from the FASB's web site at http://www.rutgers.edu/Accounting/raw/fasb/new/index.html. Additional questions will be discussed at the EITF's January 2001 meeting.

Financial Instruments Report Published

In December 2000, the FASB published a Special Report prepared by the Financial Instruments Joint Working Group (JWG) that addresses accounting for financial instruments and other items. The JWG is comprised of representatives from standard setting bodies in Australia, Canada, France, Germany, Japan, New Zealand, five Nordic countries, the U.K., and the U.S., as well as the International Accounting Standards Committee. The Special Report recommends certain changes to accounting for financial instruments and other similar items, including:

- Measurement of all financial instruments at fair value;
- Recognition of virtually all gains and losses resulting from changes in fair value of financial instruments in the income statement during the periods in which they arise;
- Elimination of special accounting for financial instruments used in hedging relationships;
- Adoption of a components approach under which parts of certain transferred financial assets are derecognized, while other parts continue to be recognized; and
- Expansion of disclosures about financial instruments, financial risk positions, and income statement effects.

Although the Special Report is not on the FASB's formal agenda, it is related to its current project on reporting financial instruments at fair value and may provide input for its future deliberations. The Special Report is available on the web at www.rutgers.edu/Accounting/raw/fasb/new/index.html, or from the FASB Order Department at (800) 748-0659. The comment

letter deadline is June 30, 2001. NAREIT will be discussing this issue with its Accounting Committee and other NAREIT members to determine whether the formation of a task force and response is warranted.

SEC Comments, Rules and Guidance

AICPA Asked to Define Non-GAAP Measures

In a November 22 letter, SEC Chief Accountant Lynn Turner asked the AICPA to undertake a project that would "provide common definitions to a core set of non-GAAP performance measures including critical success factors and key performance indicators." Turner cited the recent phenomena of companies routinely trading at price/earnings ratios "approaching stratospheric dimensions" as leading to the urgent need to identify "value drivers" or performance measures that can provide insights into current market valuations and enhance predictive value.

A FASB panel known as the Business Reporting Research Project has released a report, *Improving Business Reporting: Insights into Enhancing Voluntary Disclosures*, that provides a framework to help companies identify additional disclosures that would benefit communications with investors. The report (available on the web at http://www.rutgers.edu/Accounting/raw/fasb/) suggests that a company identify what it believes to be its critical success factors and provide relevant disclosures. However, Turner notes in his letter that the report does not provide definitions that would standardize the content of disclosures.

Turner suggests that the AICPA, with its broad constituency and specialized industry knowledge, is uniquely positioned to provide the guidance necessary for ensuring that non-GAAP performance measures are of sufficient quality to meet the needs of the capital markets. Non-GAAP performance measures mentioned by Turner as needing standardized definitions include Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA), revenues per employee, marketing as a percent of revenues, and revenue from new product introductions. The FASB report and any future AICPA initiatives could have an impact on the reporting and disclosure of Funds from Operations (FFO). The full text of Turner's letter is available at http://www.sec.gov/offices/account/aicakpis.htm.

Officials Comment on Fair Value Accounting

In recent speeches and letters, SEC officials and staff have commented on the need for standard setters to develop valuation models and methodologies used to measure fair value and the auditing of those measurements. In an October 24, 2000, speech to the Governing Council of the AICPA, SEC Chairman Arthur Levitt discussed the need for the profession to improve the type of information provided to investors, including the development of "valuation models that result in consistent, comparable and fair values of assets and liabilities" – not only financial assets and liabilities.

In a November 17 letter to the AICPA, SEC Chief Accountant Lynn Turner challenged the profession to make the development of fair value accounting and auditing guidance a top priority. Expanding Chairman Levitt's remarks, Turner listed a number of conditions that create a need for better guidance on estimating fair values and auditing those estimates, including:

- An economy that has evolved considerably since core accounting standards were developed;
- SEC reporting problems attributable to unreliable estimates of fair value;
- the issuance of accounting standards that require the measurement of assets and liabilities at fair value without providing "how to" guidance for estimating those values (e.g., IAS 40 requiring fair value reporting and/or disclosure for investment property); and
- pending standards projects that would require assets and liabilities to be measured at fair value.

Lastly, at the AICPA National Conference on Current SEC Developments in December, SEC Deputy Chief Accountant Jackson Day echoed the foregoing comments, including the belief that all financial instruments should be

measured at fair value, while at the same time not abandoning historical cost information. With historical-cost measures still considered useful to investors, it was suggested that during a transition period, historical costs could be reported along with fair values. Focusing on the practical issues of measuring financial instruments at fair value, Day said that recommendations for the measurement of fair value "should be extended to other assets and liabilities when GAAP requires that they be measured at fair value."

The full text of Levitt's and Day's speeches, and Turner's letter, are available at:
Levitt:
http://www.sec.gov/news/speeches/spch410.htm
Day:
http://www.sec.gov/news/speeches/spch36.htm
Turner:
http://www.sec.gov/offices/account/valuguid.htm

Pooling-of-Interests Guidance

On November 8, 2000, SEC staff members in the Division of Corporation Finance and the Office of Chief Accountant published guidance on how certain issues affect the qualifications for the pooling-of-interests method for business combinations. The guidance is in the form of interpretations covering topics on treasury stock rules, gain or loss on asset sales subsequent to a pooling, personal holding companies, and financial statement requirements. The guidance also refers parties interested in additional interpretations to a White Paper titled, "Pooling of Interests: Alterations of Equity Interests (47c) and Asset Dispositions (48c)," published by The Business Combinations Task Force of the AICPA. The full text of the SEC guidance can be found at http://www.sec.gov/offices/corpfin/cfbcafaq.htm, while the AICPA White Paper is located at http://www.aicpa.org/belt/intpool.htm.

New Auditor Independence Rule

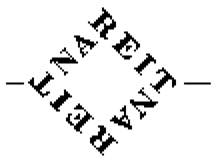
To address concerns that accounting firms may not be able to provide truly independent audits to clients who are paying them for a multitude of other services, in November 2000 the SEC voted unanimously to adopt a new rule, *Revision of the Commission's Auditor Independence Requirements.* The updated Auditor Independence Rule, which is effective February 5, 2001, seeks to prevent conflicts of interest between accounting firms and the clients they audit by barring auditors from providing nine different types of consulting services for their audit clients. Of the nine categories, seven were for the most part already barred by the SEC or accounting profession rules: bookkeeping, valuation, actuarial, broker-dealer, and legal services, as well as human resources and management functions.

The two categories of services that for the first time are limited include information technology and internal audit. Under the new rule, auditing firms are prohibited from supervising an audit clients' information technology function. However, provided certain criteria are met, information technology consulting, design, and implementation would be permitted. With regard to internal audit services, an audit firm will be permitted to perform up to 40 percent of an audit clients' internal audit work (measured in terms of hours). The new rules provide an exception from the internal audit restrictions for audit clients with assets less than $200 million.

Audit firms continue to be prohibited from providing any service to a client that is subject to a contingent fee arrangement.

Certain annual proxy statement disclosures are required by the new rule, including the total dollar amount of the audit fee, the total dollar amount of the information technology consulting fees, and all other fees for services provided by the auditors. In addition, a company will have to state that its audit committee has reviewed the fees paid to the auditor and the audit committee consideration of whether the provision of the non-audit services is compatible with maintaining the auditor's independence.

The new rule liberalizes certain financial and employment relationships between audit firms and their clients. The restriction on who cannot invest in an audit client would primarily be limited to those that work on the



audit or can influence an audit. Employment restrictions are limited to positions in which a person can influence the audit client's accounting records or financial statements if held by a "close family member" of the auditor.

Although the new rule is effective February 5, 2001, there are certain transition provisions. With respect to new restrictions on certain non-audit services, there is an 18-month transition period prior to effectiveness. In addition, certain existing financial interests and employment relationships that would impair independence under the new rule are grandfathered through May 7, 2001.

NAREIT Millennial Meetings Schedule
Mark your calendar for this year's meetings schedule. The Law & Accounting Conference will be held May 2-4 at The Renaissance Washington Hotel, Washington, D.C. The Annual Convention is set for October 10-12 at The Sheraton Chicago Hotel & Towers, Chicago, Illinois. The Accounting Committee will meet on the afternoons of Wednesday, May 2 and October 10. The SFO Workshop heads back to the east coast at the Park Hyatt Philadelphia on December 3&4. Program information on each event will be distributed in upcoming months. If you have any questions, please contact Natalie Williams at (202) 739-9443 or nwilliams@nareit.com.

Any questions about industry accounting and financial reporting practices should be directed to George Yungmann, Vice President, Financial Standards, at (202) 739-9432 or gyungmann@nareit.com, or David Taube, Director, Financial Standards, at (202) 739-9442 or dtaube@nareit.com.