

Real Estate Accounting

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NAREIT Submits Comment Letters on Cost Capitalization Proposals

On November 15, 2001, NAREIT's Cost Capitalization Task Force submitted its comment letters in response to the American Institute of Certified Public Accountant's (AICPA) and Financial Accounting Standards Board's (FASB) proposals that would establish uniform criteria for when costs associated with property, plant and equipment (PP&E) should be capitalized and expensed. The AICPA's proposed Statement of Position (SOP), *Accounting for Certain Costs and Activities Related to Property, Plant and Equipment*, includes capitalization accounting guidance for PP&E for all industries, while the proposal from the FASB would amend Statement of Financial Accounting Standards No. 67 (Statement 67), *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to exclude from the scope of SFAS 67 the accounting for the capitalization of costs and initial lease-up related to real estate projects acquired or developed for rental.

The major issues addressed by the Task Force in its letter to the AICPA included the:

- increased administrative expenses by requiring detailed component accounting;
- implicit elimination of the composite/group methods of depreciation;
- elimination of deferred cost accounting associated with PP&E;

- change in accounting for property taxes, insurance and ground rentals by requiring that the capitalization of these items cease "no later than the date initial operations commence in any portion of the building or structure"; and
- increased expenses by requiring the expensing of certain indirect and overhead costs currently permitted to be capitalized.

Conceptual issues discussed in the letter included the proposal's inconsistencies related to:

- componentization and the contrary movement of investment property accounting that has been adopted internationally (International Accounting Standard No. 40 (IAS 40), *Investment Property*);
- the elimination of deferred cost accounting and the definition of an asset under FASB Concepts Statement No. 6, *Elements of Financial Statements*; and
- the limitation of capitalizing certain indirect and overhead costs and the conflict with existing level "A" generally accepted accounting principles (GAAP) that provide for a "full-costing" approach.

The comment letter to the FASB generally echoed these conceptual concerns and requested that the Board withdraw their proposed amendments to Statement 67. Similarly, the letter to the AICPA requested that the AICPA exclude investment property from the



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provisions of the SOP that would modify Statement 67 accounting, as well as the detailed componentization requirements.

In a January 2002 follow-up letter to both the AICPA and the FASB, NAREIT emphasized the inconsistency between the detailed componentization required by the proposed SOP and the “integrated-operating-entity” concept underlying IAS 40. The letter reiterates NAREIT’s request that investment property be exempted from the detailed componentization requirements in light of the broad commitment by standard setters to the global convergence of financial standards.

In addition to NAREIT’s Task Force comment letters, more than 20 real estate companies separately submitted comment letters. NAREIT would like to thank all those that supported this important industry effort, especially Task Force Chair Pam Bruno, Vice President, Controller and Chief Accounting Officer, BNP Residential Properties. NAREIT’s comment letters are available in the Accounting Issues section of www.nareit.com.

NAREIT’s outreach efforts to ensure other industries were aware of the proposals also were very successful. The AICPA has received more than 400 comment letters, many of which were from industries and companies that attended NAREIT’s September industry briefing. The comment letters submitted by other real estate organizations, Financial Executives International, as well as groups representing railroads, electric and gas utilities, generally supported NAREIT’s positions. In addition, the comment letters from KPMG and Ernst & Young were very supportive of our positions.

The AICPA and FASB are evaluating all of the comments from constituents and, we expect, will modify the proposed SOP. Because of the volume of comments received and issues raised, we anticipate that the effective date of the proposals will be delayed (originally proposed to be effective for fiscal years beginning after June 15, 2002).

NAREIT Issues Alert, Submits Comments on Debt Extinguishment Accounting

On December 13, 2001, NAREIT distributed a National Accounting Alert based on the FASB’s November 2001 issuance of an Exposure Draft that proposes the rescission of Statement 4, *Reporting Gains and Losses from Extinguishment of Debt*. The rescission of Statement 4 would eliminate the **requirement** that all gains and losses from the extinguishment of debt be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. However, a company could continue to classify transactions as extraordinary items if they meet the criteria in paragraph 20 of APB No. 30, *Reporting the Results of Operations – Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. Paragraph 20 of APB 30 requires that the event or transaction be both unusual in nature and infrequent in occurrence.

Because real estate companies frequently and routinely extinguish debt, this proposal would, in most cases, eliminate the ability to report these transactions as extraordinary items unless they meet the criteria in APB 30. Since the gains and losses from debt extinguishments would be included in continuing operations under generally accepted accounting principles, they would be included in the calculation of Funds From Operations (FFO).

The FASB has proposed that Statement 4 be rescinded because subsequent to Statement 4 being issued in 1975, the use of debt extinguishment has become an ongoing part of the interest risk-management strategy of many companies. The rescission would be applicable as of the beginning of the fiscal year in which the new standard is issued (expected in 2002). However, financial statements issued prior to the fiscal year of adoption would not have to be restated to reflect this change in accounting.

The comment letter deadline is January 14, 2002. NAREIT has submitted a comment



letter supporting the proposal, but suggesting that it be effective on a prospective basis, beginning in the fiscal year after the issuance of a final standard. NAREIT's comment letter and National Accounting Alert are available in the Accounting Issues section of www.nareit.com.

NAREIT Submits Comment Letter to FASB on Discontinued Operations

On December 27, 2001, NAREIT submitted a comment letter to the FASB regarding the changes Statement 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, could require for the reporting of discontinued operations. Certain parties have interpreted SFAS 144 to require the extension of discontinued operations to **all** "components" of an entity, rather than to **only** "significant components." Accounting for discontinued operations requires that results of operations for all periods presented, as well as gains/losses from the assets disposed, be shown as "discontinued operations." For real estate companies that frequently dispose of "insignificant components," this reporting could create considerable confusion among financial statement users by requiring the constant reclassification of previously reported operating results related to disposed components.

When the Board issued its July 2000 Exposure Draft of the proposed standard, the reporting for discontinued operations was applicable or extended **only** to a "significant component of an entity." Further, the proposal provided that an entity assess whether a component of an entity is significant by considering all relevant quantitative and qualitative facts and circumstances. In the final Statement, the Board chose not to define the term *significant* to allow for judgement in determining whether a disposal transaction should be reported in discontinued operations. However, the final Statement eliminated the provision that would allow an entity to assess the significance of a component. In its letter, NAREIT requested that the Board clarify its intent regarding the reporting for the disposal of investment property judged to be an insignificant component of an entity.

In its review of other Statement 144 application issues, the Board recently clarified that the disposal of an equity method investment, by itself, should not be reported as a discontinued operation under Statement 144. Financial instruments, including investments in equity securities accounted for by the equity or cost method, are excluded from the scope of Statement 144 (paragraph 5(d)). Further, the operations related to an equity method investment (that is, the investor entity's share of the earnings or losses of the investee entity) are not sufficient to establish a component of the investor entity (paragraph 41).

The Board is expected in the near term to provide implementation guidance on Statement 144. A copy of the NAREIT comment letter is available in the Accounting Issues section of www.nareit.com.

NAREIT To Issue National Policy Bulletin on Joint Ventures

NAREIT's Best Financial Practices Council plans to shortly issue a National Policy Bulletin that discusses the need for information regarding joint ventures. With the real estate industry's increased use of joint ventures to raise capital or undertake development projects, the complexity associated with the financial reporting of joint venture arrangements has led financial statement users to seek a better understanding of these arrangements through enhanced disclosure. The Council prepared the Bulletin to assist companies in the development of joint venture disclosures by providing examples of disclosures from current real estate company reports to shareholders.

A complete copy of the Bulletin will be available in the Accounting Issues section of www.nareit.com.

Update on FASB Activities Sets New Course on Consolidations

Rather than develop a consolidations policy based on a control-based notion, the FASB in November 2001 decided as an interim step to focus its efforts on improving accounting practice in four specific situations, including:

- so-called “strawman” situations when a company has a nominal interest, but a substantive economic interest;
- entities that lack sufficient independent economic substance;
- convertible instruments and other contractual arrangements that involve latent control; and
- the distinction between participating and protective rights.

The prescribed procedures and guidance addressing these situations, which is planned to resolve issues related to special-purpose entities (SPE), partnerships, and other noncorporate structures, would be in the form of a new standard. The FASB hopes to gain additional knowledge about consolidations issues through this work, and upon its completion, plans to continue its consideration of the proposals in the 1999 Exposure Draft, *Consolidated Financial Statements: Purpose and Policy*.

New Projects Adopted and Considered

With the addition of three new projects, the FASB has set forth an ambitious technical agenda. The projects include reporting financial performance, disclosures about intangibles, and the codification and simplification of accounting literature.

The project on reporting financial performance could have a significant impact on how items are reported in financial statements. It would seek to address concerns about the spread of pro forma earnings measures, as well as the lack of common definitions for financial performance and key financial measures or indicators of financial performance.

According to the FASB, the primary objective of the project is to (1) determine how to improve the quality of information displayed in financial statements to facilitate an evaluation of an entity’s financial performance and (2) ascertain that sufficient information is contained in the financial statements to permit calculation of key financial measures used by investors and creditors. By adopting the proposal’s “minimum approach,” the FASB’s project will focus on whether certain line items, subtotals,

and totals should be defined in future standards and required to be shown in both interim and annual financial statements. However, it will not define how key financial metrics or ratios should be calculated. Notably, Board members have expressed concern about staying within the scope of the project.

The intangibles project would seek to establish standards for improving disclosure of information about intangible assets that are not presently recognized as assets in financial statements. These would include intangible assets that are generated internally or written off immediately after being acquired. The primary goal of the project would be to provide new quantitative and qualitative information, with a secondary goal of initiating the development of a method for recognizing internally generated intangible assets in the financial statements. The FASB timetable includes issuance of an exposure draft in the third quarter of 2002 and a final standard in the second quarter of 2003.

The codification and simplification project would seek to address what has come to be known as “standards overload” by making the retrieval of accounting rules easier, as well as eliminating redundancies and complex rules. A goal of the project would be the creation of a searchable database that would include topical guidance and literature from the FASB, EITF, SEC, and AICPA.

Finally, the Board also decided to issue a prospectus seeking comment on a proposed standard-setting effort on revenue recognition. If initiated, this project also could include an examination of the definition of a liability. Issuance of the proposal, which will have a 60-day comment period, is planned for January 2002.

EITF Reporting Guidance for Business Interruption Insurance

In November 2001, the FASB’s Emerging Issues Task Force (EITF) concluded that companies should have flexibility in how they classify payouts they receive from insurance policies covering business interruption insurance. Issue 01-13, *Income Statement Display of Business Interruption Insurance*

Recoveries, was put on the Task Force's agenda as a result of the September 11 events. To classify a business interruption insurance recovery as an extraordinary item, the event would have to meet the criteria in APB 30.

Instead of specifying where on the income statement business interruption insurance recoveries would be displayed, the Task Force conclusion requires disclosures about the nature of the event that led to the recoveries, the aggregate amount of the recoveries, and where in the income statement the amounts can be found.

AICPA Issues Audit Risk Alert

The AICPA recently issued a 2001-2002 Audit Risk Alert covering real estate industry developments. The Alert is designed to provide auditors information about the business environment in which real estate companies operate, including recent economic, technical, and professional developments that could affect audits. The Alert also summarizes emerging practice issues and current accounting, auditing, and regulatory developments. Copies of the Alert can be obtained from the AICPA by calling 888-777-7077.

Update on SEC Activities

SEC Cautions Companies, Alerts Investors on Pro Forma Financials

With the recent attention on "pro forma" financial reporting, the Securities and Exchange Commission (SEC) on December 4, 2001, issued cautionary advice to companies and tips for investors regarding the use of "pro forma" financial information in press releases. Since Funds From Operations (FFO) and other measures such as Earnings Before Depreciation and Deferred Taxes (EBDDT) represent forms of pro forma reporting, the cautionary advice is applicable to real estate companies.

Concerned that the presentation of earnings and results of operations on a basis other than GAAP could be misleading if it renders reporting under GAAP difficult to understand, the SEC warns companies that the antifraud provisions of the federal securities laws apply to the issuance of pro forma financial information. The SEC advises companies to

describe the principles upon which the pro forma presentation is made. The SEC will not consider a presentation of financial results on a basis other than GAAP to be misleading if a company explains how it has deviated from GAAP and provides the amounts of the deviations. Reporting FFO in accordance with the White Paper on Funds From Operations, particularly reconciling FFO to GAAP net income, should not be considered misleading.

In a separate release, investors are alerted that pro forma financial information is not prepared in accordance with GAAP, and are advised to read the financial statements of a company because they contain financial information that may not be readily apparent from press releases. The SEC suggests that when reviewing pro forma financial information, investors consider what assumptions and omissions the company has made. In addition, the SEC recommends that investors compare pro forma results with GAAP results in order to understand any differences.

The cautionary advice and investor alert on the use of "pro forma" financial information are available on the web at: www.sec.gov/rules/other/33-8039.htm and www.sec.gov/investor/pubs/proforma12-4.htm, respectively.

Issues Cautionary Advice on Accounting Policy Disclosures; To Consider New Rules

On December 12, 2001, the SEC issued a reminder to company managements, auditors, audit committees, and their advisors that investors require full transparency of accounting policies and the application of the policies must be appropriate. The SEC believes that disclosures required under certain accounting and SEC rules could be enhanced. Accordingly, during the coming year, the SEC intends to consider new rules to develop more disclosures about the accounting policies that management believes are most important to the company's financial condition and operating results. Prior to the consideration of new rules, the SEC encourages companies to include in their MD&A full explanations, "in plain English," of their "critical accounting policies." The



cautionary advice is available on the web at:
<http://www.sec.gov/rules/other/33-8040.htm>.

Adopts Enhanced Disclosures for Stock Compensation Plans

On December 19, 2001, the SEC adopted a new rule, *Disclosure of Equity Compensation Plan Information*, that amends the Securities Exchange Act of 1934 disclosure requirements applicable to information on equity compensation plans in annual reports filed on Forms 10-K and 10-KSB, as well as proxy and information statements. The amendments require a new table about equity compensation plans that both have been and have not been approved by a company's security holders. For each type of compensation plan, registrants must disclose the number of securities to be issued upon the exercise, and the weighted-average exercise price, of all outstanding options, warrants and rights, as well as the number of securities remaining available for future issuance. The new disclosure requirements are applicable to annual reports to be filed for fiscal years ending on or after March 15, 2002 and for proxy and information statements for meetings of, or action by, security holders occurring on or after June 15, 2002. Early compliance is permitted. The Final Rule is available on the web at: <http://www.sec.gov/rules/final/33-8048.htm>.

Recommends Improvements to Regulation FD

On December 6, 2001, the SEC issued a report, *Regulation FD Revisited*, examining the impact of the new rules issued to end the selective disclosure of important or "material" company information to analysts. The report recommends that the SEC provide companies with additional guidance on materiality so that

the companies have more definitive information about what has to be made public under Regulation FD. A second recommendation suggests that the SEC should incentivize companies to provide more information by allowing greater use of technology to satisfy Regulation FD's public information dissemination requirements. Finally, the report recommends that the SEC should closely examine post-Regulation FD market information and filings to better determine the regulation's impact on the depth and quality of company information in the marketplace.

The SEC's goal is to use what it has learned from its April 2001 roundtable discussion and industry surveys to refine the regulation to increase marketplace information. The report, which also includes a transcript of the roundtable discussion, is available on the SEC's website at:
www.sec.gov/news/studies/regfdstudy.htm.

NAREIT 2002 Meetings Schedule

Get set for this year's meetings by saving the following dates on your calendar. The Law & Accounting Conference will be held May 8-10 at The Broadmoor Resort, Colorado Springs, Colorado. The Annual Convention is set for November 6-8 at the San Francisco Marriott, San Francisco, California. The Accounting Committee will meet on the afternoons of Wednesday, May 8 and November 6. Although not finalized at this time, the SFO/IR Workshops are tentatively planned for early December in New York. Program information on each event will be distributed in upcoming months. If you have any questions, please contact Catherine Kaempffer at (202) 739-9427 or ckaempffer@nareit.com.

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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.