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In this issue:

- AcSEC Issues Cost Capitalization ED; FASB Issues ED to Amend Statement 67
- AcSEC Plans Scope Expansion of Joint Ventures Proposal
- FEI/NIRI Earnings Release Guidance
- SEC Activities
  - Guidance on Accounting for Management Fees
  - Guidance on Push-Down Accounting
  - GAO Report on Accounting Issues
  - Fair Disclosure Roundtable
- Update on FASB Actions
  - Reverses Decision on Estimating Cash Flows
  - Completes Business Combinations Project
  - Approves Cash Flow Hedge Guidance
- NAREIT 2001 SFO Workshop

AcSEC Issues Cost Capitalization ED; FASB Issues ED to Amend Statement 67

On June 29, 2001, the Accounting Standards Executive Committee (AcSEC) of the AICPA issued its long awaited Exposure Draft (ED) of its proposed Statement of Position (SOP), *Accounting for Certain Costs and Activities Related to Property, Plant and Equipment.* Concurrently, the Financial Accounting Standards Board (FASB) has issued a proposal that would amend Statement of Financial Accounting Standards (SFAS) No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*. The AcSEC's SOP includes capitalization accounting guidance for property, plant and equipment (PP&E) for all industries, while the FASB's proposal would amend SFAS 67 so that the capitalization of costs related to real estate projects acquired or developed for rental would be consistent with the AcSEC's proposal.

These proposals could increase real estate company expenses by requiring:

- detailed component accounting;
- a charge for the remaining net book value of replaced property, plant and equipment or a component; and
- the expensing of certain indirect and overhead costs currently permitted to be capitalized.

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

The comment letter deadline for both proposals is October 15, 2001. The proposals are available on the web at: http://www.aicpa.org/members/div/acctstd/edo/joint_ed.htm. If you are interested in joining NAREIT's Cost Capitalization Task Force, please contact David Taube at (202)739-9442 or dtaube@nareit.com.

AcSEC Plans Scope Expansion of Joint Ventures Proposal

On June 19, 2001, AcSEC met to discuss the scope 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.* AcSEC concluded, based on comment letters, that because the proposal would result in dramatic changes to practice, the scope of the project should not be restricted to only real estate joint ventures and should be applicable to all industries.

AcSEC's conclusion is consistent with the position taken in the comment letter submitted by NAREIT's Joint Ventures Task Force (available under Accounting Issues in the Members Only section of www.nareit.com), as well as other comments received. In response to these

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comments, AcSEC instructed its task force to revise the project prospectus to address the application of the equity method for investments in all industries. AcSEC plans to consider the new prospectus at its September meeting. If the revised prospectus is subsequently approved by the FASB, the AcSEC would issue a revised ED. Alternatively, the FASB could decide to make accounting for joint ventures a FASB project.

NAREIT would like to thank all who helped compose NAREIT's comment letter, including Task Force Chair Mary Ann Beaupre (Taubman Centers), as well as those individuals and companies that submitted more than 15 letters in support of NAREIT's positions. We believe these letters influenced the AcSEC's decision to not proceed with the project as proposed (i.e., limited to real estate). NAREIT and its task force will continue to monitor the project and submit comments when appropriate.

FEI/NIRI Earnings Release Guidance

In an effort to improve consistency and clarity among companies for the presentation and analysis of results, on April 27, 2001, the Financial Executives International (FEI) and the National Investor Relations Institute (NIRI) issued best practices guidelines for earnings press releases.

The guidance recommends that earnings press releases should include "reported" results for the period presented under generally accepted accounting principles (GAAP). Although "pro forma" results (e.g., "cash basis," "adjusted," "underlying," "ongoing" or "core") may be more analytically useful, the guidance suggests that GAAP results provide a critical framework for pro forma results. If pro forma results are used to supplement the period's GAAP results to clarify both the period's performance as well as future prospects, they should always be accompanied by a reconciliation to GAAP results. Further, the reconciliation between GAAP and pro forma results should be consistently presented for comparable periods.

The guidance was developed to address concerns of the Securities and Exchange Commission (SEC). At a May 15, 2001, meeting of the District of Columbia Bar Association, SEC Commissioner Isaac Hunt said that companies continue to manipulate financial statements, including the use of pro forma accounting "to disseminate an idealized version of their performance." A concern is that pro forma statements are not audited and may not be reconcilable with financial statements filed with the SEC.

The guidance also suggests that earnings press releases should include analyses of operating results, as well as a discussion of both positive and negative factors significantly affecting revenue, profitability and other key financial indicators that measure the health of the company. The complete guidance can be found on the web at: http://www.fei.org/news/FEI-NIRI-EPRGuidelines-4-26-2001.cfm.

SEC Activities

Guidance on Accounting for Management Fees

At an April meeting of the FASB's Emerging Issues Task Force (EITF), SEC staff made an announcement related to accounting for property management fees that are performance-based. In the SEC's Staff Accounting Bulletin No. 101 (SAB 101), *Revenue Recognition in Financial Statements*, Question 8 is concerned with the accounting by a lessor for contingent rents based on a lessee's sales volume. In its interpretive response, the SEC staff concluded that it is inappropriate to "recognize revenue based on the probability of a factor being achieved. The **contingent revenue** (emphasis added) should be recorded in the period in which the contingency is resolved." Since the issuance of SAB 101, other arrangements have been identified that are similar to contingent rent arrangements. One example is a property management contract in which the property manager can receive additional compensation for exceeding a specified level of operating or investment performance (e.g., operating profits, cash flow or fair value of the real estate).

A key difference between a contingency based on the lessee's sales volume and a contingency based on the operating performance of a property is the probability of reversal. It would be very rare for a lessee's sales volume to

decline once it has surpassed the breakpoint -- the lessor is generally assured that the contingent rent will not have to be reversed. However, there is a greater chance that a property manager would have to reverse all or a portion of contingent revenue due to deteriorating operating or investment performance.

The SEC addressed the appropriateness of a property manager recording income from performance-based incentive fees (contingent rent) at interim dates under arrangements in which the fee is not finalized until the end of a specified period of time. The SEC indicated that, based on informal surveys, it found that a majority of property and investment managers do not record any incentive fee income until the end of the contract year (Method 1). However, some companies record revenue for the amount that would be due under the agreement at any point in time if the contract were terminated at that date (Method 2).

In its announced guidance, the SEC staff said they would not object to the use of either method. However, they indicated a preference for Method 1, believing it to be more consistent with the analysis in Question 8 of SAB 101, which provides that revenue should not be recognized based upon the probability of a factor being achieved. Further, this method eliminates the potential that revenue recognized in one quarter would be later reversed.

In its decision to permit Method 2, the SEC staff concluded that the calculated revenue may be considered realizable at an interim date due to the termination provisions in the arrangement (i.e., contracts of this type are typically terminable by either party with reasonable notice at the end of each quarter). In addition, the method results in revenue recognition that reflects the periodic performance of the manager and does not consider future performance. The SEC staff also stated that its position would not change if the manager did not have termination rights during the term of the contract.

The SEC staff stated it would object to a variation of Method 2 in which the amount of revenue that would be recognized would be reduced to the extent management believes it is likely that a portion of the calculated amount would be lost due to future performance. To consider future performance in determining the amount of revenue to recognize is inconsistent with the requirement that the fee be determinable, as well as Question 8 of SAB 101.

Registrants are required to disclose the accounting policy used for these arrangements in accordance with APB Opinion No. 22, *Disclosure of Accounting Policies*, and SAB 101, as well as whether the company has recorded any revenue that is at risk due to future performance contingencies, the nature of the contracts giving rise to the contingencies, and, if material, the amount of any such revenue recorded.

The foregoing provisions are required to be adopted no later than the first fiscal quarter of the fiscal year beginning after December 15, 2001 (January 1, 2002 for calendar-year companies). Accounting changes required to conform to this guidance should be calculated as of the beginning of the quarter of adoption and presented as a change in accounting principle. Early adoption is permitted, but if it occurs in any quarter other than the first quarter of the fiscal year, the prior quarters should be restated.

Guidance on Pushdown Accounting

The SEC staff also made an announcement regarding the applicability of SAB 54, *Application of "Pushdown" Basis of Accounting in Financial Statements of Subsidiaries Acquired by Purchase*, to transactions involving: (a) a series of purchases of ownership interest in the entity and (b) multiple investors, acting as a group, that obtain substantially all of the ownership interest in an entity.

The SEC staff indicated that pushdown accounting should be used by a company that becomes substantially wholly owned as a result of a series of related and anticipated transactions. In ascertaining whether a company has become substantially wholly owned, pushdown accounting would be required if at least 95 percent of the company has been

acquired (unless the company has outstanding public debt or preferred stock that may impact the acquirer's ability to control the form of ownership of the company), permitted if 80 percent to 90 percent has been acquired, and prohibited if less than 80 percent of the company is acquired.

The SEC staff also believes it is appropriate to aggregate the holdings of investors who both mutually promote an acquisition and collaborate on the subsequent control of the entity in which they invest. Under the "mutual promotion and subsequent collaboration" model, pushdown accounting would be required if a company becomes substantially wholly owned by a group of investors who act together as effectively one investor and are able to control the form of ownership of the company.

The foregoing guidance is to be applied prospectively to transactions initiated after April 19, 2001.

GAO Report on Accounting Issues

The General Accounting Office (GAO) released a report on June 14, 2001, recommending certain actions the SEC should take to make more transparent the process by which they arrive at decisions about accounting issues. Based on research conducted by the GAO and the experiences of registrants, the report concludes that "the SEC's process for handling accounting issues and basis for its positions are not always apparent."

With the most complex issues in accounting being submitted to the SEC staff, the GAO recommended that the SEC provide registrants with better information about:

- the status of reviews;
- the assignment of accounting cases and reviews to staff members;
- the SEC's consultations with other accounting institutions with respect to deciding cases; and
- coordination between the SEC's Office of the Chief Accountant and the Division of Corporation Finance.

The complete report, *Securities and Exchange Commission: Reviews of Accounting Matters Related to Public Filings*, is available on the web in pdf form at: http://frwebgate.access.gpo.gov/cgi-bin/useftp.cgi?IPaddress=162.140.64.21&filename=d01718.pdf&directory=/diskb/wais/data/gao.

Fair Disclosure Roundtable

At the SEC's public roundtable on April 24, 2001, participants including issuers, analysts and investors urged SEC officials to provide clarification on the new Regulation Fair Disclosure (FD). Although many believe it is too early to determine the full impact of the regulation, most are seeking implementation guidance. In response, Acting SEC Chairman Laura S. Unger and Commissioner Isaac Hunt indicated a willingness to pursue a clear definition of materiality associated with Regulation FD, as well as a list of "best practices" addressing acceptable behavior. It appears that the SEC will take some action, including the issuance of a report on the regulation.

Update on FASB Actions

Reverses Decision on Estimating Cash Flows

In connection with the FASB's continuing deliberations of its asset impairment and disposal proposal, *Accounting for the Impairment or Disposal of Long-Lived Assets and for Obligations Associated with Disposal Activities*, the Board has reversed a conclusion in its earlier exposure draft that would have required the use of the complex, probability-weighted expected cash flow method for estimating future cash flows. The final standard will permit either an expected cash flow or best-estimate approach for estimating future cash flows of assets to be held and used. This change was requested in NAREIT's comment letter (available under Accounting Issues in the Members Only section of www.nareit.com) and in statements made at the Board's January 2001 Impairment Roundtable discussion.

The Board also clarified the reporting of subsequent changes in fair value less cost to sell of an asset held for sale. If a loss is recognized for any initial or subsequent write-down of the asset to fair value less cost to sell, a gain for any subsequent increase in fair value less cost to sell would be recognized, but not in excess of the loss previously recognized.

The FASB expects to issue a final standard in September 2001.

Completes Business Combinations Project
On June 29, 2001, the FASB unanimously voted to issue its rules on accounting for business combinations, as well as related guidance on accounting for acquired goodwill and other intangible assets. Statement 141, *Business Combinations*, and Statement 142, *Goodwill and Other Intangible Assets*, will both be published by the end of July. The Board recently concluded that the pooling-of-interests method for business combinations would be prohibited for business combinations initiated after June 30, 2001. The separate standard providing guidance for accounting for goodwill and other intangible assets will reflect the FASB's decision to eliminate goodwill amortization and require periodic goodwill impairment testing. Impairment losses resulting from required transitional tests of impairment will be reported as a change in accounting principle.

In a recent decision related to accounting for goodwill, the FASB decided that goodwill should be tested for impairment annually rather than on an events-and-circumstances basis as provided in its February 2001 proposal. However, interim testing would be required when:

1. an event or circumstance occurs between annual tests that might reduce the fair value of a "reporting unit" below its carrying value;
2. a more-likely-than-not expectation exists that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed; and
3. a significant asset group within a reporting unit is tested for recoverability under SFAS No. 121.

A "reporting unit" is the same as or one level below an "operating segment," as the term is used in SFAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*. It is the level at which segment management reviews and assesses the performance of the operating segment.
The Board also addressed goodwill accounting for subsidiaries that prepare separate GAAP financial statements. Goodwill reported on the separate GAAP financial statements of a subsidiary (either public or private) should be tested for impairment as if the subsidiary was a stand-alone entity. Any impairment loss recognized would not be pushed up to the parent company. However, when an impairment loss is recognized on the subsidiary's books, goodwill of the reporting unit(s) of the parent company in which the subsidiary resides would be required to be tested for impairment.

For calendar-year companies, the effective date for Statement 142 is January 1, 2002. Impairment testing for existing reporting units would be required within six months of adoption. Impairment losses would be treated as a change in accounting principle. Impairment losses resulting from tests after the first six months of adoption would be reported as part of operating income.

Approves Cash Flow Hedge Guidance
On June 27, 2001, the FASB approved the Derivatives Implementation Group's (DIG) conclusion on Issue G20, *Cash Flow Hedges: Assessing and Measuring the Effectiveness of an Option Used in a Cash Flow Hedge.* This decision will have an impact on how option premiums could be capitalized, as well as the timing and earnings recognition of option premiums on certain interest rate protection agreements. Companies will be able to defer the recognition of the changes in the fair value attributable to time value prior to the completion of the hedged transaction. Assuming a fully effective hedging relationship, rather than recognizing the changes in periodic earnings, the changes will be recorded in Other Comprehensive Income (OCI) and amortized from OCI into earnings over the period in which the option is held. NAREIT is working with the audit firms to further determine the impact of this conclusion on industry accounting.

NAREIT 2001 SFO Workshop

The Senior Financial Officers (SFO) Workshop is scheduled for Philadelphia, Pennsylvania at the Park Hyatt Philadelphia on December 3 &4. The program begins on the evening of December 3rd with a reception and dinner discussion. The following day will include a full program featuring sessions on capital markets, accounting, finance and other management issues. The program is designed exclusively for corporate member financial executives, such as CFOs, Controllers, Treasurers, Vice Presidents of Finance and Chief Accounting Officers. Look for program information in the mail in September.

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