NARAEIT Real Estate Accounting

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National Association of Real Estate Investment Trusts®

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AICPA Rethinks Cost Capitalization Proposal

Since the close of the comment period in the fall of 2001, the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountant's (AICPA) has met twice to review its proposal that establishes standards for when costs associated with property, plant and equipment (PP&E) should be capitalized or expensed. Based on discussions at the two meetings, there has been a significant shift in the direction of the proposal from what was originally proposed. Items of relevance to real estate companies include:

- Component accounting – A review of the component accounting provisions of the proposal, including what level of detail the proposal intended to require, have led AcSEC members to express concerns about cost-benefit issues resulting from the level of detail proposed. There has been a great deal of discussion about the extent of the level of detail that should be left to the judgment of management.
- Composite method of depreciation - AcSEC directed its Task Force to develop parameters for allowing the continued use of the composite method of depreciation, similar to the parameters developed for the group-life method that is permitted in certain narrowly defined situations in the current draft of the proposal.
These parameters would provide discipline in the development of a composite life. AcSEC also plans to reconsider issues related to the removal of replaced assets from accounting records and

recognizing losses on early retirement of assets.
- Indirect and overhead costs – AcSEC has asked its Task Force to study the impact of expanding the types of employee costs that may be capitalized – beyond direct, incremental payroll and benefit costs.

In addition, there is consensus developing to have the SOP be "principle-based" rather than "rule-based." The principles being focused on include:

- Assets should be depreciated over their useful life.
- Repairs and maintenance programs should be considered in determining useful life.
- Carrying amount of PP&E should never include costs of duplicate components.

An area of concern regarding the most recent proposal is that it changes the definition of "substantially complete and ready for its intended use" to mean "a building or structure held for lease whose shell is substantially complete, but for which leasehold improvements have not yet been constructed." In the basis for conclusions, AcSEC states that it "believes that once a building shell is complete, the process of obtaining tenants and constructing leasehold improvements for those tenants is an ongoing cost of lessor operations and that the building is substantially complete and ready for its intended use in rental operations."

This position appears to completely eliminate the concept of an "initial lease-up period" considered in FASB Statement 67. Applying this new guidance to real estate taxes, insurance and ground rentals would have a negative impact on earnings. More importantly, because of the connection between Statements 34 and 67, if the definition of "substantially complete and ready for its intended use" is carried over to accounting for interest, either explicitly in new guidance or indirectly by the auditing profession's using the new rule as "most recent guidance," it would have a significantly negative impact on the earnings of developers of investment property.

NAREIT staff continues to monitor the proposal and deliberations and will attend the next meeting scheduled for July 25, 2002.

NAREIT Activities

National Accounting Updates on Statement 144

Subsequent to the Financial Accounting Standards Board's (FASB) issuance and interpretation of Statement of Financial Accounting Standards No.144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, NAREIT distributed National Accounting Updates to provide members implementation guidance on which property dispositions qualify for discontinued operations reporting, as well as the allocation of interest expense to discontinued operations. Statement 144, which took effect on January 1, 2002 for calendar-year companies, expands the definition of "discontinued operations" to include the disposition of a component of an entity that "comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of an entity." As a result, both the results of operations for all periods presented and the gains/losses from most property dispositions must be reclassified from continuing operations to discontinued operations. NAREIT's Updates, which are summarized below, are available in the Accounting Issues section of www.nareit.com.

The May 4, 2002, National Accounting Update, entitled *Implementation of FASB Statement 144*, included a paper prepared by KPMG that provides examples of property dispositions common in real estate companies and addresses whether the disposition qualifies for reporting as a discontinued operation under Statement 144. KPMG completed the paper, *Issues Related to Discontinued Operations Reporting Under FASB Statement No. 144 for Real Estate Entities*, by submitting certain issues to the FASB staff to obtain their views on how Statement 144 should be applied. Many of the issues covered include the reporting the financial results of "merchant building activities," generally conducted in taxable REIT subsidiaries.

Based on the guidance developed in the paper, it appears that the FASB is taking a very rigid stance that virtually all dispositions of income-producing properties should be accounted for as discontinued operations. The only apparent narrow exceptions are (1) when a property is being constructed under a "build-to-suit" contract and is sold immediately upon completion and (2) where there has been virtually no rental revenue reported with respect to the property sold. FASB staff advises that a company should not apply a significance notion or materiality test to the fundamental question of whether a property meets the definition of "component" as defined in Statement 144. Materiality may be considered in determining whether the disposition of a component should be reported as a discontinued operation.

On June 26, the Update titled *FASB Modifies Guidance on Allocation of Interest Expense to Discontinued Operations* was issued to notify NAREIT members that the FASB's Emerging Issues Task Force (EITF) had modified its consensus with respect to Issue 87-24, *Allocation of Interest to Discontinued Operation*s. At its June 19-20, 2002 meeting, the EITF decided to require the allocation to discontinued operations of interest on debt to be assumed by a buyer and/or debt that is required to be repaid as a result of a disposal transaction. Allocation to discontinued operations of other consolidated interest that is not directly attributable to or related to other operations of the entity will continue to be permitted based on the guidance in the original consensus.

The consensus reached by the EITF at the June 2002 meeting should be applied to disposal transactions initiated after June 20, 2002. Previously reported operating results within an entity's current fiscal year may be reclassified to reflect the consensus.

The changes in accounting resulting from the issuance of Statement 144 will have no effect on the calculation of Funds From Operations (FFO), as FFO includes operating revenues and expenses reported in results of discontinued operations. Further, FFO continues to exclude gains/losses from dispositions.

Comments on SEC Financial Reporting Proposals

In April 2002, the Securities and Exchange Commission (SEC) formally initiated its rulemaking effort aimed at "real time" reporting by issuing proposals to improve the financial reporting and disclosure system. Certain proposals would accelerate the filing of periodic reports and reports of insider transactions. Other pending SEC proposals are discussed elsewhere in this newsletter under SEC Activities. NAREIT has formed an SEC Financial Reporting Task Force from its Accounting Committee to jointly work with NAREIT's SEC Subcommittee to review and comment on the various SEC proposals. If you are interested in participating, please contact David Taube at dtaube@nareit.com. The comment letters are available either in the Government Relations section (General Real Estate Issues) or Accounting Issues section of www.nareit.com.

On May 23, 2002, NAREIT submitted a comment letter to the SEC in response to their proposal that would accelerate the filing of annual reports to 60 from 90 days and quarterly reports to 30 from 45 days. The proposal also seeks to add a requirement that public companies disclose whether they provide access to their annual, quarterly and current reports on Form 8-K on their websites at the same time they are filed with the SEC. Companies not providing web site access would have to provide reasons for not doing so.

NAREIT's comment letter supported the SEC's efforts to improve the quality of corporate disclosures. However, the letter urged the SEC to retain the current filing deadlines suggesting that the adoption of significantly reduced filing deadlines would be inconsistent with the extensive efforts and proposals aimed at improving the quality of filings. As an alternative, NAREIT suggested that if the SEC insisted on reducing the deadlines, they should be 75 days for 10-Ks and 40 days or 10-Qs.

On June 24, 2002, NAREIT submitted a comment letter to the SEC in response to their proposal that would accelerate the filing of certain insider transactions and require that they be reported on Form 8-K. This proposal would apply to certain directors' and executive officers' transactions in company equity securities and loans of money to a director or executive officer made or guaranteed by the company, collateralized by the director's or executive officer's company equity securities.

NAREIT supported the SEC's efforts that would improve the general transparency of insider transactions by reducing the amount of time between execution of an insider's transaction and is public disclosure, and increasing the scope of required disclosure about these transactions. However, NAREIT expressed concern that certain of the proposed filing deadlines may not be practical, especially with respect to reporting for outside directors and certain automatic grants under benefit plans. In addition, NAREIT suggested that certain of the reporting thresholds should be increased in order to prevent overly burdensome compliance obligations with respect to relatively small transactions.

Comments on NYSE Corporate Governance Proposals

NAREITs SEC Subcommittee, on July 16, 2002, submitted comments to the New York Stock Exchange (NYSE) on its proposals to change certain corporate governance and disclosure standards for its listed companies. In June 2002, the NYSE Corporate Accountability and Listing Standards Committee submitted a report to the NYSE's Board of Directors recommending changes to the NYSE listing standards that are designed to enhance corporate governance standards and disclosure. This includes a stricter definition of independent directors who would make up the majority of the board and all of the audit and compensation committees. After a public comment period, the NYSE Board is expected to review the comments in early August.

NAREIT's comment letter supported most of the proposed amendments to the NYSE's corporate governance listing standards. This included that, after an appropriate phase-in period, a NYSE-listed company must have majority-independent board of directors; a company's board of directors must affirmatively determine that a director has no material relationship with the listed company in order for that director to qualify as "independent"; and requiring NYSE companies to reconcile any pro forma references in press releases to GAAP net income.

In addition, NAREIT also expressed concern regarding some of the recommendations, including the proposed five-year "cooling-off" period before a former employee or a former auditor of a listed company could qualify as an independent director. NAREIT suggested it should remain at three years as in the current "independence" requirements for audit committee members. NAREIT also raised concerns regarding the difficulty under some state corporate laws of adopting a non-management director body.

For a complete copy of the report, see the Press Room section (June 6, 2002 press release) of www.nyse.com. NAREIT's comment letter is available in the Government Relations section of www.nareit.com.

Comments on FASB Guarantors Accounting Proposal

On June 21, 2002, NAREIT submitted a comment letter to the FASB in response to their proposal that would expand financial reporting and disclosure requirements for loan guarantees. Under the proposal, which would provide interpretive guidance on FASB Statements 5, 57 and 107, a company issuing a loan guarantee would be required to recognize a liability for the fair value of the guarantee and provide enhanced disclosures about potential payments or losses.

NAREIT's comment letter agreed with the proposed disclosures required by a guarantor about its obligations under guarantees. However, with respect to the recognition of a liability representing the fair value of the guarantee when issued, NAREIT suggested that the proposed recognition requirements do not provide sufficient guidance with respect to the initial and subsequent period accounting and would not address substantive needs of financial statement users. Therefore, the benefits to be derived from the proposed recognition requirements do not justify their cost of implementation. The letter supported prompt issuance of the disclosure requirements but suggested that the FASB address recognition issues in a separate, more comprehensive project.

The effective date of the proposed interpretation would be fiscal years beginning after September 15, 2002 for the initial recognition and initial measurement provisions, with any cumulative effect of application reported as a change in accounting principle in the first interim period of that fiscal year. The disclosure requirements would be effective for financial statements of interim or annual periods ending after October 15, 2002.

NAREIT's comment letter is available in the Accounting Issues section of www.nareit.com. Copies of the proposal are available on the web at: http://www.fasb.org/draft/ed_prop_interp_guarantees.pdf.

Issues National Policy Bulletin on Joint Ventures

On May 20, 2002, NAREIT's Best Financial Practices Council issued 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 and a disclosure format developed by the Council. A complete copy of the Bulletin is available in the Accounting Issues section of www.nareit.com.

Comments on FASB Derivatives and Hedging Proposal

On July 1, 2002, NAREIT's Derivatives and Hedging Task Force submitted a comment letter to the FASB in response to their proposal to amend Statement 133, *Accounting for Derivative Instruments and Hedging* Activities. The proposal would amend the definition of a derivative under Statement 133 by requiring financial contracts with comparable characteristics to be accounted for in a consistent manner and amend Statement 133 for various decisions made by the FASB's Derivatives Implementation Group.

NAREIT's comment letter supported the FASB's efforts to clarify and bring consistency to the application of accounting for derivatives and hedging. In addition, the comment letter requested that the FASB provide guidance about the application of certain provisions to interest rate swaps and foreign exchange forwards that are used by real estate companies.

The proposed Statement would be effective as of the first day of the first fiscal quarter beginning after November 15, 2002, except for certain provisions, which would be effective upon issuance of the final Statement. The provisions in the proposed Statement that relate to Statement 133 Implementation Issues that have been effective for fiscal quarters that began prior to November 15, 2002, would continue to be applied in accordance with their respective effective dates.

NAREIT's comment letter is available in the Accounting Issues section of www.nareit.com. Copies of the proposal are available on the web at: http://www.fasb.org/draft/ed_amend_st133.pdf.

SEC Activities

Financial Reporting and Disclosure Reforms Proposed

To restore investor confidence in the integrity of financial markets after widely reported events since the fall of 2001, the SEC has announced and issued a number of rules proposals. Proposals that have been formally announced would require the disclosure of critical accounting policies, principal executive certification of periodic filings, and the expansion of Form 8-K disclosures. Other proposals under consideration would require that all registrants have independent audit committees and enhance required fee disclosures of amounts paid to auditors, and prohibit auditors from providing certain non-audit services to audit clients. Other financial data being considered for disclosure would include current trend and evaluative data that company executives, bankers, and investors use to make critical decisions about a company's profitability and financial condition.

Critical Accounting Policies

On May 10, 2002, the SEC proposed formal disclosure requirements for companies to include a section regarding the application of critical accounting policies in the "Management's Discussion and Analysis" (MD&A) section of annual reports, registration statements, and proxy and information statements. The "Application of Critical Accounting Policies" section would include both disclosure about the critical accounting estimates that are made in applying accounting policies and disclosure concerning the initial adoption of accounting policies that have a material impact.

This proposal follows the SEC's December 2001 issuance of "Cautionary Advice Regarding Disclosure About Critical Accounting Policies" that sought voluntary company disclosure. Based on their review of 2001 annual filings, the SEC concluded that the voluntary approach generally failed.

The proposal defines an accounting estimate recognized in the financial statements as a "critical accounting estimate" if both of the following apply:

- the accounting estimate requires the company to make assumptions about matters that are highly uncertain at the time the accounting estimate is made; and
- different estimates that the company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of the company's financial condition, changes in financial condition or results of operations.

Disclosure about critical accounting estimates would include a discussion of: the methodology and assumptions underlying them; the effect the accounting estimates have on the company's financial presentation; and the effect of changes in the estimates.

Under the proposal, when an accounting policy with a material impact has been initially adopted a company would have to disclose information that includes: a description of the transaction or event that gave rise to the initial adoption; the impact of the adoption, discussed qualitatively, on the company's financial presentation; the accounting principle adopted and method of applying it; and the choices it had among accounting principles.

This would not apply when the initial adoption resulted solely from new accounting literature issued by a recognized accounting standard setter, but would be applicable in situations such as when events or transactions occur for the first time, or were previously immaterial in their effect but become material, or events or transactions occur that are clearly different in substance from previous ones.

The comment letter deadline is July 19, 2002. NAREIT's comment letter will be available in the Accounting Issues section of www.nareit.com. The proposal is available on the web at: http://www.sec.gov/rules/proposed/33-8098.htm.

Certification of Quarterly and Annual Reports

On June 17, 2002, the SEC issued a proposal that would require the principal executive officer and principal financial officer of a company each to certify, with respect to the company's quarterly and annual reports, that:

- they have read the report;
- the information in the report is true in all important respects as of the last day of the period

covered by the report; and

- the report contains all information about the company of which they are aware that they believe is important to a reasonable investor as of the last day of the period covered by the report.

For purposes of the proposed certification, information is considered "important to a reasonable investor" if:

- there is a substantial likelihood that a reasonable investor would view the information as significantly altering the total mix of information in the report; and
- the report would be misleading to a reasonable investor if the information was omitted from the report.

In response to events related to WorldCom Inc., on June 27, the SEC accelerated the implementation of this proposed rule for certain large companies when it issued an order that would require both the chief executive and chief financial officers of companies with revenues in excess of $1.2 billion during their last fiscal year to provide sworn statements that their most recent reports filed with SEC are both complete and accurate. The certifications are required to be filed with the SEC no later than the close of business on the first date that a company is required to file a Form 10-K or Form 10-Q with the SEC on or after Aug. 14, 2002.

The certifications will apply to reports already filed this year with the SEC, including:

- the company's most recent Annual Report on Form 10-K;
- all of the company's reports on Form 10-Q, all reports on Form 8-K and all definitive proxy materials filed with the SEC subsequent to the filing of the most recent Form 10-K; and
- any amendments to any of the above.

A list of companies affected by the order is available at: http://www.sec.gov/rules/other/4-460list.htm. An example of a sworn statement is available at: http://www.sec.gov/rules/other/4-460a.htm.

The comment letter deadline for the proposal that would require principal officers from all companies to certify their periodic filings is August 19, 2002.

New Form 8-K Disclosure Requirements and Deadlines

Also on June 17, 2002, the SEC issued a proposal that would expand the number and type of events that would be reported on Form 8-K and accelerate the deadline for filing all Form 8-K reports to two business days. The SEC has identified 11 new material or important events (see http://www.sec.gov/rules/proposed/33-8106.htm for the entire proposal) that would require a Form 8-K filing.

The comment letter deadline for this proposal is August 26, 2002.

House Subcommittee Approves Financial Accounting Standards Board Act

With the goal of preserving the integrity of the establishment of accounting standards by the Financial Accounting Standards Board, and for other purposes, on July 10, 2002, a House Subcommittee approved a bill (H.R. 5058) that would create the Financial Accounting Board Standards Act. The Act would appear to codify that standards of financial accounting and reporting promulgated by the FASB would be authoritative for the purpose of determining compliance with generally accepted accounting principles and that the duty of the FASB would be to establish and improve, after independent and impartial deliberation, standards of financial accounting and reporting.

Provisions of the Act set forth general principles for the development of accounting standards and would require that the FASB provide an annual report to the President and certain House Committees.

The Act also would provide for the establishment of an Accounting Standards Commission whose purpose would be to study and recommend steps to improve both current accounting standards and the process by which such standards are set. The Commission's analysis would include an examination of (1) the FASB's record in establishing financial accounting and reporting standards; (2) the role of accounting standards in corporate bankruptcies, audit failures, and financial reporting fraud; and (3) alternative standards setting mechanisms with the aim of proposing improvements in the manner by which financial accounting and reporting standards are established. A final report also would include recommendations for specific legislation to improve financial accounting and reporting standards.

Update on FASB Activities

Issues Statement 145 - Accounting for Debt Extinguishments

On April 30, 2002, the FASB issued Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections.* The rescission of Statement 4 eliminates 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 these gains and losses as extraordinary items if they are both unusual in nature and infrequent in occurrence as provided in paragraph 20 of Accounting Principles Board (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 Transaction*s.

The effective date is fiscal years beginning after May 15, 2002, resulting in a year-2003 effective date for calendar-year companies. This revised effective date is consistent with NAREIT's request in its industry comment letter. As part of the transition guidance, gains and losses from debt extinguishments classified as an extraordinary item in prior periods presented must be reclassified (to continuing operations) if they do not meet the criteria in APB 30.
Because real estate companies frequently and routinely extinguish debt, this proposal would appear to 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 GAAP, they would be included in the calculation of FFO.

Issues Special-Purpose Entities Proposal

On July 1, 2002, the FASB issued an Exposure Draft of a proposed interpretation of ARB 51, *Consolidated Financial Statements*. The objective of the interpretation, *Consolidation of Certain Special-Purpose Entities*, is to improve financial reporting by enterprises involved with special-purpose entities (SPEs).
Current accounting guidance requires the consolidation of subsidiaries in which a company has a controlling financial interest, usually

determined by the existence of a majority voting interest. The proposed interpretation would address the consolidation of SPEs in which the usual condition for consolidation described in ARB 51 does not apply because the SPEs have no voting interests or otherwise are not subject to control through ownership of voting interests. The proposed Interpretation would require consolidation of SPEs if a company has a controlling financial interest in an SPE. Specific criteria are provided in the proposed interpretation to determine whether a company has a controlling interest. The company would be considered the primary beneficiary of the SPE and the assets, liabilities and results of the activities of the SPE would be included in consolidated financial statements with those of the company.

The FASB expects to issue an interpretation in the fourth quarter of 2002. The proposed guidance would be effective upon issuance of the interpretation for new SPEs, while the effective date for SPEs that existed prior to issuance of the interpretation would be the beginning of the first fiscal period after March 15, 2003. Calendar-year companies would need to apply the guidance on April 1, 2003.

A copy of the proposal is available on the web at: http://www.fasb.org/draft/ed_prop_interp_spe.pdf. The comment letter deadline is August 30, 2002. NAREIT will be reviewing the proposal to determine whether its Accounting Committee should submit comments.

Initiates Project on Revenue Recognition

In May 2002, the FASB added a project on revenue recognition to its agenda. With revenue recognition issues topping the list of reasons for financial reporting restatements, the project would develop one accounting standard that would apply to a broad range of industries. As part of the project, the FASB also will reconsider its related guidance on revenue recognition in Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. The completion and issuance of a new standard is expected to take two to three years.

NAREIT 2002 SFO/IR Workshop

The Senior Financial Officers/Investor Relations (SFO/IR) Workshop is scheduled for December 2 & 3 at The Essex House in New York. The program begins on the evening of December 2nd 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, Directors of Investor Relations 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, gyungmann@nareit.com, or David Taube, Director, Financial Standards, at (202) 739-9442, dtaube@nareit.com.