

Update



NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

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FASB

Issues Proposal On Fair Value Measurements

In response to requests from constituents to improve the current guidance for measuring fair value, on June 23, 2004, the Financial Accounting Standards Board (FASB) published an Exposure

Draft, *Fair Value Measurements* (ED). The ED would replace any current guidance for measuring fair value in other authoritative pronouncements.

The ED defines fair value as the “price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties” and seeks to establish a hierarchy for measuring fair value that would apply broadly to financial and nonfinancial assets and liabilities. The fair value hierarchy groups into three broad levels the inputs that should be used to estimate fair value. The hierarchy gives the highest priority to market inputs that reflect quoted prices in active markets for identical assets and liabilities (whether such prices are quoted in terms of completed transaction prices, bid and asked prices, or rates), the next priority to quoted prices for similar assets or liabilities and the lowest priority to internal estimates and assumptions. Fair value could be measured using the following approaches:

- The market approach requires observable prices and other information generated by actual transactions involving identical, similar, or otherwise comparable assets or liabilities (including business enterprises). The estimate of fair value is based on the value indicated by those transactions.
- The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The estimate of fair

value is based on the value indicated by marketplace expectations about those future amounts. Those valuation techniques include present value techniques and option-pricing models, such as the Black-Scholes-Merton formula and lattice models, which incorporate present value techniques.

- c. For an asset, the cost approach considers the amount that currently would be required to replace its service capacity (often referred to as current replacement cost). The estimate of fair value considers the cost to acquire a substitute asset of comparable utility, adjusted for obsolescence. Obsolescence encompasses physical depreciation, functional obsolescence, and economic obsolescence and is broader than depreciation for financial reporting purposes (an allocation of historical cost) or tax purposes (based on specified service lives).

The ED does not require the use of any particular approach, but mandates that valuation techniques used to estimate fair value should be consistently applied. A change in the valuation technique(s) used would be appropriate only if the change results in a more reliable estimate of fair value. Revisions resulting from a change in the valuation technique(s) used would be accounted for prospectively, as changes in accounting estimates.

The comment period for the ED ends September 7, 2004. Please respond to George Yungmann or Gaurav Agarwal if you would like to help NAREIT draft a comment letter on this ED. The Board plans to hold a public roundtable meeting in September 2004 to gather additional input. Click [HERE](#) to access the ED.

Clears AcSEC SOP On The Scope Of The Investment Company Guide

On June 15, 2004, the FASB cleared the AICPA's Accounting Standards Executive Committee's (AcSEC) Statement of Position, *Clarification of the Scope of the Audit and Accounting Guide, Audits of Investment Companies, and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies (SOP)*.

The original Audits of Investment Companies guide and the exposure drafts of this SOP, which were the only publicly available documents until the June 15 FASB meeting, contained an explicit exclusion for REITs from the scope of this project. AcSEC confirmed this exclusion at its public meeting (attended by NAREIT) in June 2003. Due to this explicit exclusion, NAREIT did not comment on the SOP. However, our review of the final document sent to the FASB revealed that the exclusion for REITs has been removed without any public notice or public discussion.

Paragraph A-25 of the final document cleared by FASB acknowledges that, "this SOP should not provide specific requirements for REITs and that REITs should be subject to the same provisions of this SOP as other entities. AcSEC observes, however, that REITs typically would not meet the definition of an investment company because REITs are typically involved in the day-to-day management of investees in ways that are inconsistent with the activities of an investment company. For example, REITs typically develop and operate real estate." If a REIT or any other real estate company were considered an investment company under the SOP, it would have to follow GAAP requirements imposed on passive owners of real estate such as pension plans. Most significantly, these companies would be required to report investment property at fair value rather than depreciated historical cost.

We urge you to review this document (available by clicking [HERE](#)) as well and pay close attention to paragraph A-25 in Appendix A, Illustrations 10-12 in Appendix B and Appendix C (Applying the Provisions of This Statement to Entities That Hold Investment in Real Estate), and advise us if this SOP would be applicable to your company and/or clients. Please respond to George Yungmann or Gaurav Agarwal at your earliest convenience.

Publishes Proposal To Clarify The Accounting Guidance For Conditional Asset Retirement Obligations

On June 17, 2004, the FASB published an Exposure Draft, *Accounting for Conditional Asset Retirement Obligations, an Interpretation of FASB Statement No. 143 ED*, in response to the diverse accounting practices that have developed with respect to the timing of liability recognition for conditional asset retirement obligations. The proposal seeks to provide more consistent recognition of liabilities relating to asset retirement obligations and more information about future cash outflows relating to these obligations.

The exposure draft clarifies that a legal obligation to perform an asset retirement activity that is conditional on a future event is within the scope of Statement No. 143. Under the Board's proposal, an entity would be required to recognize a liability for the fair value of an asset retirement obligation that is conditional on a future event if the liability's fair value can be estimated reasonably. The ability of an entity to indefinitely defer settlement of the obligation or the ability of an entity to sell the asset prior to its retirement does not relieve an entity of the obligation. Uncertainty surrounding the timing and method of settlement that may be conditional on events occurring in the future would be factored into the

measurement of the liability rather than the recognition of the liability.

The ED provides an example of an entity that acquires a factory that contains asbestos. At the acquisition date, government regulations require the entity to handle and dispose of the asbestos in a special manner if the factory undergoes major renovation or is demolished. The ED suggests that although performance of the asset retirement activity is conditional on the factory's undergoing major renovation or demolition, existing regulations create a duty or responsibility for the entity to remove and dispose of asbestos in a special manner, and the obligating event occurs when the entity acquires the factory. Therefore, an asset retirement obligation should be recognized when the entity acquires the factory.

The proposal would be effective no later than the end of the fiscal years ending after December 15, 2005 (December 31, 2005 for calendar-year enterprises). The comment period for the exposure draft ends August 1, 2004. Click [HERE](#) to access the document.

SEC

Approves Standard For Audits Of Internal Control Pursuant To Section 404 Of The Sarbanes-Oxley Act Of 2002

As required by Section 404(a) of the Sarbanes-Oxley Act of 2002, on June 17, 2004, the Securities and Exchange Commission (SEC) approved the proposed Public Company Accounting Oversight Board (PCAOB) auditing standard for audits of internal control over financial reporting. The Auditing Standard No. 2, "*An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*," addresses both the work that is required to audit internal controls

over financial reporting and the relationship of that audit to the audit of the financial statements.

Despite controversy, the PCAOB did not scrap a requirement that auditors judge the effectiveness of audit committee members who have the power to hire and fire them. Whenever auditors find problems with audit committees, the final rule requires that they report it to the full board. The final Standard acknowledges that “the company’s board of directors is responsible for evaluating the performance and effectiveness of the audit committee; this standard does not suggest that the auditor is responsible for performing a separate and distinct evaluation of the audit committee.”

Virtually all publicly traded NAREIT member companies must begin to comply with Section 404 rules and related standards in their 2004 annual reports.

Click [HERE](#) to access the SEC release. Click [HERE](#) to access the final Standard.

On June 23, 2004, the SEC issued *Management’s Report on Internal Control over Financial Reporting and Disclosure in Exchange Act Periodic Reports: Frequently Asked Questions* and the PCAOB issued *Staff Questions and Answers: Auditing Internal Control Over Financial Reporting* to address various implementation questions for preparers and auditors in relation to the above Standard. Click [HERE](#) to access a copy of the SEC staff’s frequently asked questions. Click [HERE](#) to access a copy of the PCAOB staff’s questions and answers

Will Publicly Release Staff Comment Letters And Responses

On June 24, 2004, the SEC announced its position regarding the release of comment letters and filer responses relating to disclosure filings reviewed by the Division of Corporation Finance and the

Division of Investment Management. The SEC currently releases staff comment letters and responses to these comment letters only in response to a Freedom of Information Act (FOIA) request after the staff review is complete. In recent months, an increasing number of SEC comment letters and filer responses to them are being released publicly through the FOIA process, but only to those persons who make FOIA requests for them. The Staff believes that it is appropriate to expand the transparency of the comment process so that this information is available to a broader audience, free of charge. The Staff intends to do this through the Commission's Public Dissemination Service and on its website at www.sec.gov (EDGAR data on the SEC's Public Web site). Public access to this correspondence will no longer require a FOIA request.

The Staff will begin releasing the comment letters and response letters relating to filings made after August 1, 2004. The Staff will announce in the near future a specific date after which these documents will become publicly available; that date will depend on completion of necessary technical modifications. Correspondence will be released not less than 45 days after the staff has completed a filing review.

SEC Rule 83 (17 CFR 200.83) allows filers to request confidential treatment for some portions of a written response to a staff comment letter. That rule requires the filer to submit its response letter using two separate documents - a response to the comment letter without the confidential information, which the Staff refers to as the redacted version, and a separate paper document including the confidential information. This separate document must be properly marked as confidential in accordance with Rule 83. It is not clear if the identity of the filer will be disclosed. The Staff currently intends to release only the redacted version of response letters where there is

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a Rule 83 request for confidential treatment. Anyone wishing to seek release pursuant to FOIA of the portions of a response letter that are the subject of a confidential treatment request must submit a FOIA request for the information.

The staff may ask companies to represent in writing that they will not use the SEC's comment process as a defense in any securities related litigation against them. This request is known as a "Tandy" letter. Since it will be making all comment letters and responses publicly available, either in response to a FOIA request or pursuant to this announcement, the Staff will ask all companies whose filings are reviewed for such representation. Click [HERE](#) to access the SEC press release.

NAREIT

Comments on FASB's Exposure Draft on Share-Based Payment

As mentioned in the April 2004 Financial Standards Update, on March 31, 2004, the FASB released for public comment an exposure draft (ED) entitled *Share-Based Payment, an amendment of FASB Statements No. 123 and 95*. This ED proposes that the cost of all forms of equity-based compensation (EBC) granted to employees, excluding employee stock ownership plans, be recognized in a company's income statement. The award's cost would be measured at its fair value. While the FASB would not require the use of a particular valuation model, it prefers the binomial approach to valuing EBC at its fair value. The FASB believes that the proposed guidance will make EBC more transparent to investors. The ED would be applicable to most NAREIT member companies prospectively for fiscal years beginning after December 15, 2004, as if all share-based compensation awards granted, modified, or settled after December 15, 1994, had been accounted for using the

fair-value-based method of accounting (modified prospective method). Click [HERE](#) to access the ED.

In its comment letter dated June 30, 2004, NAREIT agreed with the FASB that all forms of EBC be recognized in a company's income statement at their fair value, and also agreed with the modified prospective method of transition. Click [HERE](#) to access NAREIT's comment letter.

2004 Internal Audit Forum

Duke Realty Corporation will host the 2004 Internal Audit Forum in Indianapolis on August 24, 2004. This invitation only event is designed for IA Directors of corporate member and will focus on a variety of topics, including: the roles and responsibilities of their respective IA functions; compliance with the Sarbanes-Oxley Act of 2002; conducting risk assessments; best practices for starting an IA function; and relationships with the external auditors. Contact Gaurav Agarwal for further details.

NAREIT

Steven A. Wechsler

President and CEO

(202) 739-9400, swechsler@nareit.com

Financial Standards/SEC Team

Tony M. Edwards

Senior Vice President and General Counsel

(202) 739-9408, tedwards@nareit.com

George L. Yungmann

Vice President, Financial Standards

(202) 739-9432, gyungmann@nareit.com

Robert R. Cohen

National Policy Counsel

(202) 739-9415, rcohen@nareit.com

Gaurav Agarwal

Director, Financial Standards

(202) 739-9442, gagarwal@nareit.com