NAREIT Financial Standards Update

National Association of Real Estate Investment Trusts®
REITs: Building Dividends and Diversification®

Financial Standards Update

FASB Fair Value Option Project Provides for Reporting Equity Investments in Joint Ventures at Fair Value and May Provide for Reporting Investment Property at Fair Value

Background

On Feb. 27, 2006, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) published a Memorandum of Understanding (Memorandum) that reaffirms the two Boards' shared objective of developing high quality, common accounting standards for use in the world's capital markets. In the Memorandum, the FASB committed to adding a *Fair Value Option* project to its agenda. The project is being completed in two phases. Phase 1 will provide an option to report certain financial assets and liabilities at fair value. Phase 2 will examine whether U.S. GAAP should provide an option to report non-financial assets and liabilities at fair value. Each phase of this project could dramatically impact our industry's financial reporting.

Phase 1

A final Phase 1 standard is scheduled to be issued in first quarter 2007. Based on the latest FASB discussions of Phase 1, this standard would allow investments in affiliates accounted for under the equity method to be reported at fair value. Therefore, a real estate company that is reporting its investment in a joint venture under the equity method could elect to report this investment at fair value. This option could be elected on a venture-by-venture basis. Since the investor's interest in the venture will be affected by the changes in value of the investment property held by the venture, the investor's earnings would include its share of the appreciation or depreciation in the fair value of the venture's property.

Phase 2

The FASB has committed to examining the accounting for investment property, *i.e.*, most income producing real estate, under Phase 2 of this project. Based on discussions with FASB members, we understand that this examination will include an evaluation of the convergence of U.S. standards with International Accounting Standard No. 40 *Investment Property* (IAS 40). This international standard requires that the fair value of investment property either be reported in the statement of financial position or disclosed in notes to the financial statements.

Highlights

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If applied to investment property and the fair value option were selected, this standard would eliminate investment property depreciation expense and changes in unrealized value would be included in net income. It is expected that the Board's initial work will result in a Phase 2 exposure draft in 2007.

In connection with this project, NAREIT has requested a meeting with the FASB to discuss NAREIT's views with respect to reporting investment property at fair value. We are currently working with the FASB staff to arrange this meeting.

Also, in connection with the issuance of FAS 157 *Fair Value Measurements* (see article below) and the Board's consideration of providing an option to report investment property at fair value, the Board has asked NAREIT to present a professional development program to the Board and its staff focused on how investment property is valued and how such value is used. This program, which is scheduled for December 15, 2006, will be developed and presented by Deborah Jackson of Weiser Realty Advisors, John Lutzius of Green Street Advisors and George Yungmann of NAREIT.

FASB Agrees to Re-examine the Definition of Discontinued Operations

Reporting the disposition of most investment property as discontinued operations has created a number of issues for NAREIT companies. NAREIT has requested that the FASB provide additional guidance with respect to this reporting that would resolve our industry's issues. One option for possibly resolving these issues would be to converge U.S. GAAP with the International Financial Reporting Standard (IFRS) for reporting discontinued operations. At the September 20, 2006 FASB meeting, the Board's staff reported that the definition of "discontinued operations" differed considerably as between U.S. GAAP and IFRS. On November 15, 2006 the FASB agreed to consider this matter in the context of its commitment to converge U.S. GAAP and IFRS. The staffs of both Boards will present alternative solutions to the Boards in January 2007.

On the positive side, the FASB and IASB have concluded that the definition of "discontinued operations" should be harmonized. On the potentially negative side, any relief for the industry could be delayed for a year or more and the FASB definition could prevail – although we believe the IASB definition is supported by the majority of IASB and FASB constituents.

In a letter dated July 17, 2006, NAREIT requested that the FASB reconsider whether all dispositions of investment property should be reported in discontinued operations. Based on the industry's experience in applying Statement of Financial Accounting Standards No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144) over 10 fiscal quarters beginning 1Q03, NAREIT requested that the FASB consider issuing some form of guidance that would exclude most asset dispositions from discontinued operations. Click HERE for NAREIT's 2006 letter.

Based on follow-up discussions with the FASB staff, we concluded that the issue of harmonizing U.S. GAAP and IFRS would be an important factor in the FASB's consideration of our request. Strengthening our request that U.S. GAAP should mirror international reporting, the European Public Real Estate Association (EPRA) submitted a letter to the FASB in support of NAREIT's views.

International Accounting Standards Board®

FASB and IASB to Develop New Lease Accounting Standards that Could Dramatically Impact Industry Reporting

As reported in the July 2006 *Financial Standards Update*, on July 19, the FASB formally added to its agenda a project to reconsider the current standards for accounting for leases. Most participants in the financial reporting arena agree that current lease accounting does not clearly portray the resources and obligations arising from many lease transactions, at least with respect to lessees. Of major concern to our industry is whether new standards will re-characterize investment property on the balance sheet and/or re-characterize rents reported in lessors' income statements. New standards will be developed in a joint project with the IASB.

The FASB and IASB have established a joint international working group to provide input on the issues to be considered in the lease accounting project. George Yungmann, NAREIT Sr. VP, Financial Standards has been appointed to this working group. Deliberations of lease accounting issues will begin in 2007 and should result in the issuance of a preliminary views document in 2008 for public comment. If you are interested in participating in a NAREIT task force that will evaluate any IASB/FASB proposals regarding lease accounting and develop NAREIT comments on these proposals, please contact George Yungmann at gyungmann@nareit.com. Click HERE for the FASB release on this topic.

NAREIT Companies Implementing FIN 48

On July 13, 2006, the FASB issued FIN 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109 (FIN 48)*. FIN 48 is intended to increase the relevancy and comparability of financial reporting by clarifying the way companies account for uncertainty in measuring income taxes. Currently, the accounting for uncertainty in income taxes, which is based upon the sustainability of a tax position, is subject to significant and varied interpretations that have resulted in diverse and inconsistent accounting practices and measurements. Click HERE for the full text of FIN 48.

While FIN 48 is effective for most NAREIT member companies beginning the first quarter of 2007, footnote disclosure of the impact of this standard on the company's financial statements will be required in 2006 year-end reporting, as required by SEC Staff Accounting Bulletin No. 74 *Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant when Adopted in a Future Period*. Some accounting firms have expressed a concern that companies are not rigorously focused on developing information for these disclosures. We urge member companies to discuss the required disclosures with their audit firm and begin evaluating any uncertain tax position toward developing the required information.

In connection with implementing FIN 48, the AICPA's Center for Public Company Audit Firms issued a discussion document on November 21, 2006 which addresses two specific questions:

- Financial statement disclosure in the quarter that FIN 48 is adopted and
- Other implementation issues, specifically the application of the SEC rules regarding

preferability letters for changes in accounting principles related to the classification of income tax-related interest and penalties.

The full document is available by clicking HERE.

International Real Estate Coalition Developing Financial Statement Model

Over the course of 2006, NAREIT has been working with an international real estate industry coalition toward developing a global real estate industry financial statement model. These organizations include the:

- Asian Public Real Estate Association
- Association for Real Estate Securitization of Japan
- British Property Federation
- European Public Real Estate Association
- Property Council of Australia
- Real Property Association of Canada

This work is in response to the FASB and IASB joint project *Financial Statement Presentation.* This project would establish standards for the content and form of each of the basic financial statements. As a prelude to this joint effort, a NAREIT task force developed a model statement of comprehensive income that was approved by NAREIT's Executive Committee in 2005. This model is being used as a basis of discussions with the international coalition.

On November 6 and 7 in connection with NAREIT's 2006 Annual Convention, we hosted a meeting of representatives of the coalition to discuss the global industry model. Also, NAREIT staff attended an EPRA Best Financial Practices Committee meeting on October 19 and 20 at which this project was discussed. We believe that the coalition is nearing consensus on a statement of comprehensive income that would be responsive to industry needs, as well as to tentative project decisions reached by the IASB and FASB. Any consensus reached by the coalition will be reviewed by NAREIT's Best Financial Practices Council and presented to the Executive Committee for review. When consensus is reached and the model is approved by NAREIT's Executive Committee, it will be presented to the IASB and FASB staffs.

Peter Mitchell, CEO, APREA

This international convergence project presents an opportunity for NAREIT and the global real estate industry to advocate the content and formats of financial statements that effectively report the economics of the business of acquiring, developing, owning and operating investment property. For example, participants from the FASB, SEC and IASB involved in this project will debate whether the performance of "core operations" should be reported under a standard, uniform definition or under a "management approach." The management approach would require that earnings from "core operations" be reported in a manner that reflects how management views operating performance.

If the management approach is chosen as the final standard, the international real estate coalition would have the opportunity to define a metric under U.S. GAAP, as well as under IFRS, that reports the economics of operating investment property from management's perspective. In addition, NAREIT will have an opportunity to advocate positions with respect to fair value reporting along the lines previously authorized by NAREIT's Leadership. This is especially important to the industry as the FASB examines harmonizing U.S. GAAP with the international standard that requires reporting, or disclosure of, investment property at fair value – as further discussed above.

International Real Estate Coalition Submits Comment Letter on IASB Proposed Changes to Accounting for Borrowing Costs

On May 25, 2006 the IASB published an exposure draft aimed at improving the accounting for borrowing costs. The proposal would amend International Accounting Standard 23, *Borrowing Costs* (IAS 23) and harmonize the accounting for such costs with the U.S. GAAP guidance provided in Statement of Financial Accounting Standards No. 34, *Capitalization of Interest Cost*.

The amendments would eliminate a major difference between the two standards' accounting treatments for borrowing costs. Borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset would have to be capitalized as part of the asset's cost. Previously IAS 23 allowed a choice to capitalize or expense such costs. The majority of real estate companies routinely capitalize borrowing costs incurred during construction of property.

The coalition of international real estate organizations (identified above) submitted a comment letter to the IASB in support of the proposed amendments to IAS 23 to remove the choice for expensing such costs. NAREIT staff attended an FASB meeting on November 15, 2006 at which the FASB staff reported that most respondents to the ED took the position that the expense option should be retained. Click HERE to access the coalition's comment letter. A final standard is scheduled to be issued in first quarter 2007.

FASB Examines Accounting for Income Taxes by REITs

The FASB has on its agenda a short-term convergence project to improve the accounting for income taxes while reducing existing differences between FAS No. 109 *Accounting for Income Taxes* and the international accounting standard, IAS 12. As part of this project, the FASB and IASB have concluded that, if income is taxed at different rates depending on whether the income is distributed to shareholders:

- Deferred tax assets and liabilities should be measured based on the undistributed rate; and
- To the extent that there is an obligation to distribute a portion of that net income, deferred tax assets and liabilities should be measured based on the distributed rate.

Both the FASB and IASB are considering how these conclusions might impact the measurement of tax expense and liability when a type of entity, such as a real estate investment trust, cooperative or mutual fund, may not have distributed net income at the balance sheet date, has no legal obligation to distribute income but in virtually all cases does so and receives a tax deduction for such distribution. In connection with this matter, the Boards have asked the staffs to develop a definition of an "in substance tax exempt entity" that would cover entities whose tax structure is set up to avoid shareholders suffering double taxation and involves tax deductions being available if the entity distributes all or almost all of its total income. A full description of this project, tentative decisions reached and issues to be resolved are available by clicking HERE.

The FASB staff has contacted NAREIT to request information regarding REITs and to discuss considerations with NAREIT as the FASB examines these issues. The FASB expects to issue an exposure draft covering this project during the first quarter of 2007.

FASB Issues Standard to Define, Measure Fair Value under GAAP

On September 15, 2006, the FASB issued FAS No. 157 *Fair Value Measurements* (the Standard). The Standard does not expand the requirements to report assets and liabilities at fair value but rather clarifies the definition of fair value, provides guidance on the measurement of fair value and sets forth disclosure requirements. Currently, more than 40 FASB standards require or permit the use of fair value measurements. The definition of fair value retained the exchange price notion used in current standards and focuses on an exit price – not an entry value. The exit price represents "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

NAREIT member companies are required to measure assets or liabilities at fair value under a number of accounting standards. This includes determining the fair value of property for purposes of measuring impairment and the fair value of assets and liabilities acquired. This standard would also be the basis for measuring the fair value of investment property if the FASB concludes that U.S. GAAP should mirror the international standard that provides an option to report investment property at fair value. See article above.

NAREIT submitted a comment letter that urged the Board to allow the use of specific information based on the reporting entity's market transactions in the measurement of fair value. This comment letter can be accessed by clicking HERE.This notion is included in the Standard's hierarchy of sources to be used in measuring fair value.

NAREIT Submits Comment Letter on SEC Concept Release

In connection with its published *Next Steps for Sarbanes-Oxley Implementation*, on July 11, 2006 the SEC published a concept release that surveyed constituents' experience and issues with respect to management's assessment of a company's internal controls over financial reporting. The release can be accessed by clicking HERE.

NAREIT formed a task force of its Accounting Committee and SEC Subcommittee to evaluate this release and develop a comment letter. NAREIT staff also participated in the U.S. Chamber of Commerce's consideration of this release. NAREIT's comment letter indicated support for the views of the U.S. Chamber of Commerce and emphasized that further guidance should:

- Clarify the purpose of internal control and implications to fraud;
- Modify AS2 based on the SEC's top-down risk-based approach to identifying and testing internal controls over financial reporting; and
- Provide additional guidance regarding the identification of key controls.

Both NAREIT's and the U.S. Chamber of Commerce's comment letters can be accessed by clicking HERE. SEC Chairman Christopher Cox has stated that he hopes that the SEC will issue revised guidance regarding the Sarbanes-Oxley Act, especially Section 404, by year-end.

Committee on Capital Markets Regulation Issues Recommendations

The Committee on Capital Markets Regulation (Committee) is an independent, bipartisan and diverse group of 22 experts from the investor community, business, finance, law, accounting and academia. It is headed by Glenn Hubbard, Dean of the Columbia School of Business, and John Thornton, Chairman of the Brookings Institution. On November 30, 2006, the Committee issued an Interim Report *Reducing Regulation and Litigation While Enhancing Shareholder Rights Will Improve the Competitiveness of U.S. Capital Markets* (Report). The Report includes 32 recommendations in four key areas:

- Shareholder rights
- Section 404 of Sarbanes-Oxley
- The regulatory process and
- Public and private enforcement.

Key findings of the Report include the following:

- U.S. capital markets no longer enjoy the competitive advantages they once had over other capital markets;
- Regulation, while critical to the U.S. capital markets, must be balanced – the costs can not outweigh the benefits;
- Currently this balance does not exist and must be restored;
- The SEC and self-regulatory organizations (SROs) should move to a more risk-based regulatory process and should rely on principles-based rules and guidance; and
- The SEC should adopt a more reasonable materiality standard for both internal controls and financial statements.

A summary of the Report is available by clicking HERE and the full Report can be accessed by clicking HERE.

NAREIT 2007 Law & Accounting Conference

NAREIT's 2007 Law & Accounting Conference will be held on March 28 through 30 at the Doral Golf Resort & Spa in Miami, Florida. Program and registration information will be available shortly. For sponsorship opportunities, please contact Meghna Mathur at mmathur@nareit.com or 202-739-9434.

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