NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

November 14, 2001

Mr. Marc Simon
Technical Manager, Accounting Standards
File 4210.CC
AICPA
1211 Avenue of the Americas
New York, New York 10036-8775

Re: Proposed Statement of Position: *Accounting* for *Certain Costs and Activities Related to Property, Plant and Equipment*

Dear Mr. Simon:

As you know, the National Association of Real Estate Investment Trusts (NAREIT) has followed and directly supported the Accounting Standards Executive Committee's (AcSEC) process and deliberations with respect to its proposed Statement of Position (SOP), *Accounting for Certain Costs and Activities Related to Property, Plant and Equipment*. NAREIT representatives have attended public AcSEC meetings at which this project has been discussed and provided AcSEC's Project Task Force with NAREIT's views and concerns based on the materials discussed at these meetings. This letter provides our comments on the June 29, 2001 Exposure Draft (ED).

NAREIT is the national trade association for real estate investment trusts (REITs) and other publicly traded real estate companies. NAREIT members include over 200 REITs and other companies that develop, own, operate, and finance investment property,[1] as well as those firms and individuals who advise, study, and service these businesses. Providing useful and relevant financial information related to investment property is of vital importance to the capital formation and investor relations activities of companies involved in these businesses.

NAREIT has, and will continue to, actively support the development of transparent accounting and reporting standards. Our goal is to responsibly advocate those standards that reflect the economic reality of acquiring, developing, owning and operating investment property. In this context, the accounting standards for capitalizing the costs of these assets are fundamental to producing useful financial reports for real estate companies that acquire, develop, own and operate investment property. These standards may have a more

[1] Investment property is also referred to as income-producing real estate, both of which are defined as real estate held for rental and/or capital appreciation.

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significant impact on the financial statements of these companies than on the financial statements of companies that simply use property, plant and equipment in the production of products or delivery of services, in view of the fact that property assets account for the great majority of member company assets and maintenance of these properties represents a significant annual cost.

This comment letter is organized as follows:

I. *Summary of Significant Concerns*

As discussed in Exhibit A attached to this letter, our most significant concerns with the proposed SOP as drafted are as follows:

- Component accounting at the detailed level prescribed by the SOP is not cost justified – it would not enhance the measurement of the cost or depreciation expense of PP&E to a degree commensurate with the cost of applying the SOP.
- The proposed SOP would effectively eliminate the group and composite methods of depreciation.
- The SOP virtually would eliminate the concept of "deferred cost/prepaid expense" accounting with respect to PP&E. This is contrary to the definition of an asset as set forth in the FASB's Concepts Statement No. 6, *Elements of Financial Statements.* We believe that this result would not allow for appropriate matching of revenues and costs and, therefore, would not produce financial reporting that would provide a faithful representation of the periodic profitability of owning and operating investment property.
- Finally, the proposed SOP would not result in more uniform accounting for capital maintenance expenditures – one of the explicit purposes of the proposal.

Based on our comments in this letter and its attached Exhibits, we respectfully request that investment property be exempted from the scope of those sections of the proposed SOP that modify the accounting prescribed in SFAS 67, as well as those sections that require detailed componentization.

II. *Scope of the Proposed SOP*

We understand and appreciate that there may be a need to provide clearer guidance with respect to:

- accounting for the costs of repairs and maintenance and long-term capital maintenance programs,
- disclosure of accounting policies governing the accounting for the cost of repairs and maintenance,
- depreciation methodology and measurement parameters, and
- providing more useful disclosures with respect to appropriate categories of PP&E and depreciation.

At the same time, and in addition to other concerns, we believe the scope of the proposed SOP extends far beyond the "Accounting Issues" identified in the project prospectus. Each of the issues identified in paragraphs 5 through 8 of the prospectus focus specifically on accounting for expenditures made subsequent to the initial installation, development or construction of PP&E. Beyond the scope indicated in the prospectus, the proposed SOP would create new accounting for:

- the initial costs of installing, developing and constructing PP&E;
- carrying costs during the initial lease-up phase of a real estate project; and
- overhead costs relating to the initial development and construction of PP&E.

Standards with respect to each of these areas for investment property are set forth in Statement of Financial Accounting Standard No. 67 (SFAS 67), *Accounting for Costs and Initial Rental Operations of Real Estate Projects*.

In addition, paragraph 4 of the prospectus specifically states that the project will not cover depreciation. As discussed further in this letter, the proposed SOP would dramatically affect universal depreciation practice – it would eliminate the group and composite methods of depreciation and would require, instead, a depreciation system that would require extensive and costly changes to current practices.

While we may not fully understand the AcSEC's/FASB's policy with respect to adherence to a project's prospectus, we believe the scope of the proposed SOP should be consistent with the project prospectus. Therefore, we believe the proposed SOP should be revised to conform to the prospectus and the revised documents re-exposed.

III. *Investment Property – a Unique Asset Recognized in Accounting Standards*

First, we understand and appreciate that certain practices with respect to accounting for costs of PP&E may not be uniform in all respects and that these areas of accounting diversity may need to be addressed. But, from our research, the specific areas of concern are accounting for costs of repairs and maintenance and long-term capital maintenance programs as opposed to the costs of developing or constructing PP&E. We have not seen evidence that accounting practices with respect to costs of developing or constructing investment property are significantly diverse. It, therefore, is difficult for us to conclude that principles contained in SFAS 67 have provided incorrect or misleading guidance for almost 20 years. Contributing to the longevity and continued relevance of SFAS 67 was the FASB's 1982 review of these principles that were originally contained in AICPA Statements of Position. We do not understand why the AICPA/FASB would want to continue to expend scarce resources on a standard that has provided clear guidance for over 20 years (since SOP 78-3 was issued) and was reviewed and re-issued by the FASB in 1982 as SFAS 67.

Second, we note that SFAS No.19 (SFAS 19), *Financial Accounting and Reporting by Oil and Gas Producing Companies*, would not be affected by the issuance of the proposed SOP. Many of the cost accumulation principles found in SFAS 19 are consistent with the principles included in SFAS 67. Many characteristics of producing oil and gas, especially the exploration and development of wells and supporting facilities, are similar to the development and construction of investment property. This is even true of accounting for costs of "dry holes/abandoned projects" and the relevance of fair value information. Therefore, we do not understand why the scope of the proposed SOP leaves SFAS 19 intact (as it should) but obsoletes SFAS 67.

And third, the economics of owning and operating investment property are far different than the economics related to PP&E used to provide goods and services. SFAS 67 and other authoritative accounting literature recognize the unique economic characteristics of "investment property." Characteristics that distinguish investment property from most property, plant and equipment include the following:

- Each property is unique in terms of location, design and tenant mix.
- Cash flows are directly associated with renting or leasing the property to unaffiliated parties.
- Future long-term cash flows generated by the property are reasonably estimable – they are supported by contracts (leases).
- In many cases, the cost of the property is funded by specifically related non-recourse mortgage debt that has been underwritten by third-party lenders on the basis of the quality of projected cash flows.
- There is an active market for the exchange of investment property.
- The value of well-maintained investment property generally increases over time.

Generally Accepted Accounting Principles (GAAP) in the U.S. have recognized the uniqueness of investment property in SFAS No. 41, *Financial Reporting and Changing Prices: Specialized Assets – Income-Producing Real Estate,* and in SFAS 67. In the international arena, International Accounting Standard No. 40 (IAS 40), *Investment Properties*, also recognizes these distinctions. Conclusions reached in this March 2000 standard are based on contemporary views of fundamental financial reporting concepts.

IAS 40, a part of the core international accounting standards that are recognized by the new International Accounting Standards Board, requires disclosure of the fair value of investment property either in the financial statements or in accompanying notes. To achieve this measurement and disclosure, it views an investment property as an integrated operating entity, a package of service potential – not as an amalgamation of hundreds of components. IAS 40 also addresses the accounting for "subsequent expenditure."

In testimony at a July 31, 2001, House Energy and Commerce Subcommittee meeting, Edward Jenkins, Chair of the FASB, stated:

> We [FASB] are committed to having a close, active and constructive relationship with the IASB [International Accounting Standards Board] and other standards setters in achieving convergence of high quality financial reporting standards around the world.

Further, as reported in the October 16, 2001 issue of *Status Report*, the FASB has reached a tentative agreement to change its agenda decision criteria "to include consideration of the prospects for cooperation and convergence with each topic added to the Board's agenda…"

To require owners/operators of investment property to dramatically move in a direction counter to the more far-reaching direction of international accounting standards seems inappropriate, unnecessary and inconsistent with the FASB's commitment to achieve international convergence of high quality accounting standards. **We believe that changing U.S. GAAP to require extensive, detailed componentization of the costs of investment property while core international standards view them as integrated operating entities, will result in the real estate industry's financial reporting and accounting systems being whipsawed as the U.S. moves toward convergence with international standards.**

IV. *Basis for Selection of Cost Accumulation Model*

In its justification of a cost accumulation model that would exclude the capitalization of certain indirect and overhead costs related to the installation, development or construction of PP&E, AcSEC analogized to SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. This is an inappropriate justification based on AcSEC's own conclusions as set forth in paragraph 80 of SOP 98-1, which states:

> AcSEC recognizes that the costs of some activities, such as allocated overhead, may be part of the overall cost of assets, but it excluded such costs because it believes that, as a practical matter, costs of accumulating and assigning overhead to software projects would generally exceed the benefits that would be derived from a "full costing" accounting approach. AcSEC considered that costing systems for inventory and **plant construction** (emphasis added) activities, while sometimes complex, were necessary costs given the routine activities that such systems support.

Similar to plant construction, the development, construction, or improvement of investment property entails certain indirect and overhead costs that represent routine activities. Clearly, these costs are part of the overall cost of the asset. Moreover, the benefits derived from a full costing approach for investment property far exceed the expense of required costing systems. Real estate companies track and account for the costs of these activities through the use of mature systems that have been developed to comply with SFAS 67. The financial results produced by these systems have been included in audited financial statements for more than 20 years.

V. *Request to Limit Scope Related to Investment Property*

We respectfully request that investment property be exempted from the scope of those sections of the proposed SOP that modify the accounting prescribed in SFAS 67, as well as those sections that require detailed componentization, for the following reasons:

- There is no evidence that SFAS No. 67 needs modification to ensure a reasonable degree of uniform accounting for the development and construction of investment property—in fact, AcSEC's July 2000 draft of the SOP (Appendix A, paragraph 46) stated that "diversity in practice is minimal" with respect to SFAS 67;
- SFAS 67 provides an appropriate long-standing cost accumulation model – reflecting the model used in SFAS 19;
- The application of SFAS 67 reflects the economics of developing and operating investment property in terms of costs recognized and returns measured by investors,
- The project prospectus did not identify accounting for these costs as an issue; and
- The proposed SOP's componentization accounting model for investment property is inconsistent with IAS 40 and is inferior in its conceptual and practical approach to accounting for this property.

Concurrently with this comment letter, we are responding to the Financial Accounting Standards Board's Exposure Draft that would amend SFAS 67. Our position is that SFAS 67 should not be amended.

NAREIT appreciates the opportunity to continue to participate in AcSEC's considerations with respect to accounting for PP&E. The positions taken in this comment letter represent consensus views of a Task Force of NAREIT members. In addition, this comment letter has been reviewed and approved by NAREIT's Best Financial Practices Council. A list of companies represented by these participants is included in Exhibit C. In addition, representatives of the major accounting firms provided advice and comments in connection with this letter. If you have any questions regarding this comment letter, please contact George Yungmann at (202) 739-9432 or David Taube at (202) 739-9442.

Respectfully submitted,

Steven A. Wechsler
President and CEO

George L. Yungmann
Vice President, Financial Standards

Exhibit A

<u>General Comments</u>

Accounting for All Distinguishable Components of PP&E as Separate Assets

The detail to which the proposed accounting carries componentization of PP&E is impracticable and difficult for us to even imagine justifiable on a cost/benefit basis.

As indicated elsewhere in this letter, the proposed level of componentization would dramatically increase the costs of accounting for PP&E. NAREIT has not developed specific estimates of <u>all</u> of these costs, but will be urging our member companies to do so. We are certain that the expansion of cost segregation studies and the more detailed approach to these studies required by the proposed SOP alone could cost a real estate company $50,000 to $100,000 per property – just to initially allocate costs to detailed components. Moreover, there would be an exorbitant total cost that would have to be incurred to achieve even reasonable accuracy in allocating trillions of dollars of net book value of investment properties at adoption of the proposed SOP. NAREIT members alone have interests in more than 27,000 individual property investments. Assuming a per-property cost at the low end of the range of $50,000, the cost to initially allocate the net book value would approximate $1.35 billion. We cannot even begin to estimate what the cost would be to complete these allocations for the more than four trillion dollars of investment-grade real estate in the United States. It is clearly not practicable nor cost-justified to allocate this cost to the level of components required by the proposed SOP. This would be a massive and expensive undertaking with minimal enhancement to reported results. AcSEC should seriously consider field-testing this proposed guidance as part of its post-comment-letter review of the proposed SOP.

Further, we do not believe that the Board or AcSEC have adequately considered the effort and cost that would be required to apply the detailed level of PP&E componentization to large, complex PP&E – such as investment property. Paragraphs 58 and 59 of the ED discuss disclosures and suggest that "buildings and building improvements," represents a major category of PP&E and that this category be sub-categorized into tenant improvements, integral equipment and the building shell. We are very concerned that the discussion in these paragraphs suggests that AcSEC believes that a real estate project consists of far fewer components (at the level defined by the proposed SOP) than actually exists in the case of investment property. The level of components implied by these paragraphs may be acceptable to the real estate industry – but it is far less detailed than the level actually required by the ED. There are hundreds of replaceable PP&E components in a single investment property. While it is possible to account for the cost of each one of these components, we do not believe that the result would provide significantly more useful information than the composite or group methods of accounting for major categories of components.

In addition, with respect to component asset accounting, we do not believe that the cost of multi-million and even billion-dollar acquisitions can be reasonably assigned to replaceable components (e.g., a $ 25,000 motor in major mechanical equipment, the interior façade of a bank of elevators, the treads on an escalator, the hundreds of appliances in a large apartment project, etc.). In July 2001, Equity Office Properties Trust acquired Spieker Properties, Inc., the assets of which consisted primarily of a portfolio of office buildings. This acquisition was valued at more than $7 billion. We cannot imagine how this value could be allocated to tens of thousands of detailed property components as required by the proposed SOP.

Some have suggested that real estate companies have information already available from cost segregation studies to enable them to implement the proposed SOP. This is not the case. First, cost segregation studies undertaken today are not completed for even a majority of real estate properties. Second, in the great majority of cost segregation studies, investment property is simply grouped into three broad categories – personal property, buildings and land improvements. The personal property, which generally only accounts for about 5% of the property's total value, is further detailed by small components. The remaining 95% of a property's cost is not broken down into components or even individual systems (i.e., mechanical, electrical, integral equipment, etc.). While very detailed cost segregation is possible, we estimate that it would double or triple the current cost of these studies that range from $30,000 to $50,000 per property, depending on the complexity and size of the property.

And finally, with respect to the detailed level of componentization called for by the proposed SOP, we would assume that physical identification of components would be required to be completed and reconciled to accounting records for audit purposes. This would, of course, increase the cost of audits.

We note that in the Forward to the ED, one of the four criteria required for FASB clearance of AcSEC proposed projects and documents is that "the benefits of the proposal are expected to exceed the costs of applying it." We also note that the project prospectus states:

> AcSEC believes that the benefits arising from consistent application of accounting principles and the improved comparability of financial statements will exceed the costs of implementation.

We would appreciate the AcSEC sharing with us their analysis or rationale that would justify the cost of the detailed accounting called for in the proposed SOP.

This proposed detailed componentization accounting would effectively eliminate the use of the composite and group methods of depreciation – currently acceptable accounting methods universally used in practice. Under the composite method of depreciation, assets or components of assets with different service lives are depreciated over the weighted useful lives of the individual assets or components of the group. If an individual asset or component is retired before or after its useful life, any implicit gain or loss is charged/credited to accumulated depreciation. This practice is justified because individual components are retired both before and after the end of their useful lives.

The group method of depreciation does not utilize weighted average useful lives. It groups assets or components of assets having similar useful lives and measures depreciation expense for the groups. Both the composite and group methods of depreciation result in appropriate financial reporting at reasonable cost.

The composite or group method of depreciation is referred to and considered acceptable in current accounting literature, including:

- SFAS No. 19, Appendix B;
- AICPA Industry Audit Guide; Audits of Airlines (Chapter 3 – Depreciation, paragraphs 3.101 and 3.102); and
- AICPA Industry Audit Guide; Audits of Agricultural Producers and Agricultural Cooperatives (paragraph 6.55).

The composite method of depreciation also is described in many accounting texts. See Exhibit D for specific references.

We are very concerned that the proposed SOP would eliminate accounting methods that have solid bases in both accounting literature and practice.

Paragraph A48 of the ED indicates that the group or composite method of depreciation would not be precluded if an entity can demonstrate that they "produce results related to gross PP&E, accumulated depreciation, depreciation expense, and gains or losses on replacements or disposals of PP&E that are not materially different from those obtained under the accounting prescribed in paragraphs 49 through 56 of this SOP. . . ." Alternative approaches of componentization may provide the basis for reconciling results of the alternative approach with the results of the detailed component methodology called for in the proposed SOP, except for measuring gains or losses on replaced components. This specific reconciliation cannot be accomplished without also implementing component depreciation to the level described in the ED. Therefore, the notion that financial statement preparers can avoid the detailed level of componentization required by the proposed SOP through comparisons and reconciliations with alternative methods is illogical. We urge the AcSEC to consider more reasonable and cost justifiable alternative approaches for PP&E cost componentization.

Componentization – alternative approaches

We believe that there are approaches to component cost accounting that would be more appropriate and cost effective. While we have not had the opportunity to fully develop such an approach, one possibility is for the cost of a PP&E asset to be broken down into categories by the useful lives of components at a reasonable level of detail. These categories might number a dozen or more for investment property. This degree of break down would depend on the number of major components and the degree to which their useful lives were similar. Components within these "useful-life buckets" would be accounted for using the group method of depreciation. No "losses" (remaining net book values) would be recognized in earnings at the time of replacement. These "losses" could be minimized through more precise determination of useful lives of major components and regular comparisons of the parameters used with actual experience.

Deferred Cost Accounting

The proposed SOP would virtually eliminate the concept of "deferred cost accounting" with respect to PP&E. It concludes that <u>only</u> costs of PP&E and PP&E components and the <u>direct</u> costs of acquiring, developing and/or installing them may be capitalized. This would apply to any project stage. It would not allow for the deferral and amortization of long-term capital maintenance, development and other costs that may not be considered PP&E or PP&E components—even where evidence indicates that such costs would unquestionably provide future economic benefits. Examples of these costs are:

- Preliminary costs as defined in the ED
- Indirect costs of development, construction and installation
- Incremental overhead costs related to employees directly related to the development or construction of PP&E
- Costs that may not meet the definition of PP&E in the proposed SOP but that extend the life or add value to a PP&E asset

Moreover, the proposed SOP provides guidance that is inconsistent with the matching of costs with related probable future revenue streams. These conclusions are contrary to the fundamental definition of an asset set forth in FASB Concepts Statement No. 6 (Statement 6), *Elements of Financial Statements*, and inconsistent with precedent established by broad financial standards such as SFAS No. 34 (SFAS 34), *Capitalization of Interest Cost*, and SFAS 19. SFAS 34 provides an excellent example of appropriate principles for cost accumulation and the matching of costs and revenues. SFAS 19 provides for a cost accumulation model similar to that provided for in SFAS 67 – a model that has and continues to produce, the most appropriate financial reporting for large, long-term physical assets. We strongly object to the imposition of a cost accumulation model that differs significantly from the model reflected in SFAS 19. Paragraph A7 of the ED indicates that AcSEC chose not to address the issues required to conform the proposed SOP to SFAS 19, but no basis for this conclusion is given. We request that a basis for this significant conclusion be provided so that we might understand the rationale for this inconsistent application of the proposed SOP.

With respect to "in service stage" costs, we believe that AcSEC's conclusions as discussed in paragraphs A30 and A31 of the ED ignore concepts set forth in Statement 6. The concept of deferred costs is well established in Statement 6. Paragraph 145 of Statement 6 states:

> Accrual accounting uses accrual, deferral, and allocation procedures whose goal is to relate revenues, expenses, gains, and losses to periods to reflect an entity's performance during a period instead of merely listing its cash receipts and outlays. Thus, recognition of revenues, expenses, gains and losses and the related increments and decrements in assets and liabilities – including <u>**matching of costs and revenues, allocation, and amortization – is the essence of using accrual accounting to measure the performance of entities**</u> (emphasis added).

Further, paragraphs 246 through 250 of Statement 6 clearly establish the basis for deferring costs that "do not by themselves qualify as assets" but may provide future economic benefit.

Paragraphs A30 and A31 of the ED conclude that costs related to PP&E may only be capitalized as fixed assets or charged to expense. There is no provision for the deferral of costs that provide probable future economic benefit. These paragraphs also imply that the practice of capitalizing these costs may be based on the presumption that (i) they extend the life of the asset or (ii) "simply because it [an expenditure] is a large monetary amount or it does not occur on a recurring basis." These factors are not necessarily relevant to the capitalization decision. Certain costs should be capitalized simply based on a conclusion that they meet the definition of an asset provided by Statement 6.

As further discussed below, the costs of long-term capital programs, as well as all costs that support initial development, related to investment property provide economic benefits beyond the period in which they are incurred and should, therefore, be capitalized and amortized over the periods benefited. Long-term capital maintenance programs have been referred to as refurbishments, renovations, rehabilitations and similar terms. The ED suggests that these programs/costs relate to past operations. This is not so for investment property.

Investment property (office buildings, shopping malls, apartments, industrial buildings, hotels, health care facilities, etc.) requires long-term capital expenditures in order to perpetuate and/or enhance their market position and class level. These properties are generally classified as class A, B or C properties. A property's class level has a <u>direct</u> impact on the level of future rental income. Properties are developed to achieve a certain class level that provides the basis for achieving rents consistent with such class level. The great majority of leases supporting these rents call for <u>long-term</u> rental income streams. The properties are regularly maintained, but may require capital expenditures to maintain their class level and, therefore, their ability to command commensurate rents <u>upon releasing</u>. Another example of programs, the full cost of which should be capitalized, would be post-acquisition costs contemplated in the acquisition pricing. All costs of these programs should be capitalizable based on Statement 6.

In summary, while there may be some lack of uniformity in the area of deferred cost capitalization, to eliminate the ability to match costs against highly probable, if not certain, future economic benefits results in inappropriate reporting of operating results. The final SOP's guidance for accounting for long-term capital costs should allow for the capitalization of costs which provide future economic benefit even if they do not represent physical PP&E – consistent with Statement 6. Otherwise, these costs will be accounted for on a cash basis – clearly in opposition to the foundation upon which GAAP has been developed.

Accounting for Property Taxes, Insurance and Ground Rents

The Exposure Draft's discussion of these carrying costs primarily relates to real estate assets. Current accounting for these costs generally follows the accounting for interest costs. In fact, paragraph 6 of SFAS 67, which provides the accounting for property taxes and insurance, refers to SFAS 34, *Capitalization of Interest Costs.* Clearly, ground rent is a cost of financing – similar to interest costs. As indicated previously, SFAS 34 provides excellent guidance with respect to criteria required in order to capitalize these carrying costs.

Paragraph 32 of the ED provides two conclusions that may conflict with accounting under SFAS 34. Both of these conflicts relate to the concept of accounting for what might be considered a single project as multiple projects – as illustrated in Example 9 of the ED.

The first conclusion suggests that, "if a property under construction remains in operation while the construction takes place, costs incurred for property taxes, insurance and ground rentals should be capitalized only if they are incremental and directly attributable to the construction activities." We assume that, if a separate portion of a property is closed down for construction (not in operation), all carrying costs related to the portion under construction would be capitalized. This would be consistent with the conclusions with respect to "property under construction" included in Paragraph 32.

The second conflict is clearer. Paragraph 32 concludes that the capitalization of property taxes, insurance and ground rentals should cease "no later than the date initial operations commence in any portion of the building or structure." For large real estate projects, this accounting would cause a significant mismatch between costs and revenues. For example, under the proposed SOP, if a 400,000 square foot office building were being developed and the first tenant occupied 25,000 square feet, costs of property taxes, insurance and ground rentals applicable to the entire 400,000 square foot building would be charged to the rental income stream from the 25,000 square feet of space leased. The earnings (or probably loss) resulting from this accounting would not provide appropriate information with respect to the future profitability of the property.

In this example, the appropriate accounting would be to allocate the property taxes, insurance and ground rents proportionally between space generating revenue (the 25,000 square feet) and the non-revenue generating space (the 375,000 square feet) as the building leases up. Limits to the capitalization should be required in terms of the maximum length of time subject to this allocation. In addition, the property would be subject to impairment testing.

We strongly urge AcSEC to use Paragraphs 17 and 18 of SFAS 34 as a model for accounting for property taxes, insurance and ground rentals – as illustrated to some extent in Example 9 of the ED. At the same time, we disagree with the last paragraph of Example 9. All land <u>directly associated</u> with a project under development should be subject to the capitalization of property taxes, insurance and ground rents.

<u>A Few Final Comments</u>

We do not believe the proposed SOP will achieve uniformity in practice.

From our reading of correspondence from the SEC to AcSEC, as well as the project prospectus, one of the primary purposes of the proposed SOP is to substantially narrow the diversity in accounting for PP&E repair and maintenance costs and capital improvement expenditures. We do not believe the proposed SOP achieves this goal for the following reasons:

- Neither components nor the level of componentization are clearly defined.

- Some companies would avoid detailed componentization through the use of relatively high capitalization thresholds. Other companies would continue capitalizing costs based on lower thresholds.
- Some companies may outsource development/construction/installation costs and others would use internal staff. The proposed SOP's limitation on the capitalization of indirect and overhead costs related to the use of internal employees would result in cost differentials as compared to costs of the same activities that are outsourced.
- Estimates of the remaining net book value of replaced components would be used – as opposed to actual net book values.
- Allowing two methods of adoption would result in long-term diversity.

This diversity would especially disadvantage smaller companies that would generally use lower thresholds to avoid earnings volatility and may need to utilize external resources to determine the net book value of components at date of adoption.

The costs associated with implementing the proposal are not justified.

A number of our comments discuss the extensive costs of allocating the current net book value of PP&E at the date of adoption. We could not begin to estimate the cost to complete this allocation for trillions of dollars of real estate costs. We also noted the required expansion of the use of cost segregation studies and the doubling or tripling of costs of far more detailed studies in order to segregate components to the detailed level called for in the proposed SOP. In addition to these costs, accounting for the detailed level of individual components rather than grouping and depreciating them at a more reasonable level would result in increased ongoing administrative costs.

The cost of implementing the proposed SOP may be reduced to an acceptable level if :

- the level of componentization is raised to group all PP&E and PP&E components into useful-life categories,
- the group/composite depreciation methods are not eliminated but are used to depreciate all assets in a single useful-life category, and
- the requirement to measure the remaining net book value of components replaced is eliminated from the proposal.

Unless the detailed accounting requirements of the proposal are reduced, the effective date of the SOP is too aggressive.

The adoption of the SOP, as currently proposed, would require substantial planning, systems enhancements and organizational changes. We believe that adoption should be deferred until no sooner than eighteen months after the final SOP is issued.

Exhibit B

<u>Comments on Areas Requiring Particular Attention</u>

This section of our comment letter addresses the issues raised in AcSEC's cover letter to the ED.

Issue 1
There is diversity in accounting for both costs and revenues related to reimbursable capital expenditures associated with investment property. This issue should be addressed separately from the proposed SOP. We are prepared to assist in addressing this issue. We have not identified other areas of the SOP that would conflict with existing lease accounting standards.

Issue 2
We generally agree with the *Project Stage Framework* except that we strongly believe that the full cost of long-term capital programs should be capitalized and amortized against future economic benefits. Our view is more fully discussed under "Deferred Cost Accounting" in our general comments. If it would facilitate the identification of costs to be appropriately capitalized, we urge the AcSEC to define the commonly used terms contained in paragraph 1 of the ED.

Alternatively, criteria could be established that would provide for the capitalization of the costs of certain capital programs. In fact, the minutes of AcSEC's January 2000 meeting indicate a tentative conclusion that "subsequent" real estate costs would be charged to expense unless one of a number of criteria were met. One of these criteria was "the costs are incurred to alter the functionality, extend the life, or improve the safety or efficiency of the real estate, whereby the condition of the real estate after the costs are incurred would have to be improved as compared with its initial condition." This view was carried to a subsequent draft. We believe that these or similar criteria would be operational.

Developing capitalization criteria for PP&E would mirror the practice of setting criteria for the capitalization of web site development costs incurred in the operating stage as discussed in paragraph 8 of EITF 00-2, *Accounting for Web Site Development Costs.*

Issue 3
Significant costs may be incurred during the preliminary stage of developing investment property. We believe it is inappropriate to expense these costs if the project is eventually completed. We recommend that these costs be capitalized/deferred until a determination is made as to whether it is probable that they will result in a successful development. This accounting would mirror the accounting for "exploration costs" as required by paragraph 19 of SFAS 19. The application of impairment tests would ensure that these costs are recoverable or, if not, the property's costs would be written down.

Issue 4
This is a very broad question that may have wider implications than accounting for general and administrative and overhead costs. While we agree that certain general and administrative costs should be expensed as incurred, we believe that there may be costs that are neither "directly

identifiable costs" as defined in the SOP nor general and administrative and overhead costs that should be expensed. Such costs should be capitalized as a part of the cost of major capital programs. These costs would include the costs of material and labor that directly support major capital programs and development/construction/installation activities. For example, a company would capitalize costs incurred for support personnel employed in a construction function who may be supporting multiple projects. This cost accumulation model would result in PP&E costs similar to the cost of outsourcing development/construction/installation activities.

A second example would be costs of executive management effort. In some cases, executive level staff is integrally involved in the development of investment property. The criteria for capitalizing or expensing costs of executive effort should be based on the same principles provided in the proposed SOP for other costs. Paragraph 28 of the ED states that "costs related to PP&E that are incurred during this [acquisition or construction] stage should be capitalized if they are directly identifiable with the specific PP&E or the costs meet the requirements in paragraphs 32 through 35." Our general view with respect to deferring non-PP&E direct costs is more fully discussed under "Deferred Cost Accounting" in our general comments.

Issue 5
We agree with AcSEC's conclusion and would recommend that SFAS No. 34, *Capitalization of Interest Costs*, be used as a guide for applying it. See further discussion of this issue under "Accounting for Property Taxes, Insurance and Ground Rents" in our general comments.

Issue 6
We do not agree with this conclusion and refer to our related comments in "Deferred Cost Accounting" in our general comments and in Issue 4 above.

Issue 7
This conclusion is, in the great majority of cases, impracticable and, therefore, not operational. Contractors generally do not provide data that segregates removal costs from installation costs. Therefore, we believe that removal costs should not be distinguished from costs of installing replacement PP&E or PP&E components.

With respect to demolition costs, we believe that the costs of demolishing any structure that was not being used in an entity's core business activities (e.g. a structure used for incidental operations) should be capitalized if the demolition is completed in connection with the development of a new or expanded property.

Issue 8
We strongly disagree with these conclusions. See our discussion under "Deferred Cost Accounting" in our general comments and in Issue 4 above. All costs of long-term capital maintenance programs should be capitalized and amortized against the probable, if not certain, future economic benefits.

Issue 9
Again, we disagree with this conclusion. We strongly believe that costs of restoring the service potential of PP&E should be capitalized – in addition to the cost of replacements that would be

capitalizable under this SOP. At the same time, we do not support the "built-in-overhaul" method of accounting for these costs. These costs should be capitalized/deferred as incurred and amortized over an appropriate period.

Issue 10
We believe that AcSEC's guidance is appropriate. Also, we would not attempt to define what kinds of changes in intended use would constitute "a pattern" because we do not believe that such definition could cover all facts and circumstances. This should be left to the judgment of management and auditors.

Issue 11
As stated earlier in this comment letter, we believe that the cost accumulation model for real estate properties developed for rental or to be used by an enterprise should be consistent with the cost accumulation model for real estate property developed for sale. This model is contained in SFAS 67 and should not be modified.

Issues 12, 13 and 14
These issues relate to component accounting and, therefore, are covered by our views as expressed under "Accounting for All Distinguishable Components of PP&E as Separate Assets" in the general comments section of this letter. To reiterate, we support the use of componentization to a reasonable level – but the detailed level required by the proposed SOP is unreasonable.

Issue 15
We have no comment on this issue.

Issue 16
We believe that providing alternatives to the transition accounting will result in diversity in practice and lack of comparability between companies. At the same time, in the event AcSEC decides to proceed with transition alternatives, we believe that paragraph 71.a. needs to be clarified and we strongly disagree with "the penalty," as it has been called in AcSEC discussions, with respect to applying paragraph 71.b. pursuant to methodology described in paragraph 53.

The second paragraph of Paragraph 71.a. describes the method to be used in determining the accumulated depreciation for each component. We assume that these calculations do not apply if the total <u>net</u> book value of PP&E is allocated based on the relative fair market value of each component. The AcSEC should clarify whether paragraph 71.a. is calling for the allocation of the net book value or gross book value when using relative fair value for the allocation.
The method of determining the net book value of PP&E subsequent to adoption of the SOP as described in paragraph 53 is simply not logical. Members of AcSEC were accurate in labeling this methodology "the penalty." If a composite <u>weighted</u> average depreciable life of a PP&E asset is 40 years and a component having a 15 year life (<u>reflected in the weighted average life used</u>) is replaced at the end of 10 years, the applicable accumulated depreciation is 10/15 times the original cost – not 15/40 times the original cost.

In this example, while the weighted average life of the PP&E asset is 40 years, the short-lived component has been depreciated over its 15-year useful life. To measure the accumulated depreciation related to a replaced, short-lived component using the full weighted average life rather than the life of the short-lived component used to develop the weighted average does not result in an accurate measurement of the net book value of the component. Why should this adverse result ("the penalty") be applied to an entity that simply decides to defer allocation of the net book value of its PP&E until after its adoption of the SOP?

Issue17
We believe the conclusions covered by this issue are appropriate.

Issue 18
We agree with the approach described in this issue.

Issue 19
We disagree with the conclusion that the accumulated depreciation difference described in this issue should be allocated back to the accumulated depreciation of each component. The transition allocation called for in Paragraph 71.a. will consume enormous effort and cost. We would not want to have the results of this effort arbitrarily changed. Therefore, we recommend that the difference be accounted for as a "cumulative effect of accounting change."

Exhibit C

NAREIT Task Force and Best Financial Practices Council – Comment Letter Contributors

AMB Property Corporation	Keystone Property Trust
AMLI Residential Properties Trust	Kilroy Realty Corp.
Associated Estates Realty Corp.	Kimco Realty Corp.
BNP Residential Properties Inc.	Koger Equity Inc.
BRE Properties Inc.	LaSalle Investment Management Securities
CAPREIT Inc.	Mack-Cali Realty Corp.
Chatham Financial Corporation	Manufactured Home Communities Inc.
Christopher Weil & Co.	MeriStar Hospitality Corp.
CNL Fund Advisors	Mills Corp.
Corporate Office Properties Trust	Pennsylvania REIT
Cousins Properties Inc.	Reckson Associates Realty Corp.
Crown American Realty Trust	Security Capital Group Inc.
Equity One Inc.	Simon Property Group
Equity Residential Properties Trust	SL Green Realty Inc.
Forest City Enterprises	Summit Properties Inc.
General Growth Properties Inc.	Taubman Centers Inc.
Green Street Advisors	The Rouse Company
Host Marriott Corp.	Vornado Realty Trust
HVP Capital Management Inc.	Washington REIT
Intellectual Capital Markets	Watson Land Company

Exhibit D

References To The Composite Method Of Depreciation

The proposed SOP implicitly eliminates the composite or group method of depreciation as it is defined in a number of references (listed below) and as it is widely applied in practice. The specific issue is the accounting for replacements. Many companies use the composite/group method of depreciation for major portions of an investment property and do not recognize gains and losses on retirement of components within the major categories.

Under the proposed SOP (paragraph 51), the original cost and accumulated depreciation of a replaced component would be estimated and any remaining net book value would be recorded as an expense. Requiring such recognition would result in a significant change in practice and represent a clear inconsistency with the widely accepted definition of the composite/group method of depreciation.

One of the earliest cites of "group depreciation" can be found in ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, chapter 9, Depreciation.

In addition, we have reviewed the discussion of the composite/group method of depreciation in the following texts:

- *Accounting Principles*; Fess & Warren; Seventeenth Edition, 1993, page 389.
- *Intermediate Accounting*; Keiso and Weygandt; Seventh Edition, 1992, pages 550 – 552.
- *Intermediate Accounting;* Welsch and Zlatkovch; Eighth Edition, 1989, pages 490 – 493.
- *Intermediate Accounting*; Smith & Skousen; Eighth Edition, 1984, pages 396 – 398.
- *Intermediate Accounting*; Meigs, Johnson and Keller; McGraw Hill, 1963, pages 556 – 557.

Specifically, all of these references indicate that no recognition of gain or loss is required under the composite/group method of depreciation upon retirement/replacement of a component.