

Quarterly

National Association of Real Estate Investment Trusts®

Event Notices:

NAREIT Accounting Committee Meeting

NAREIT Annual Convention
The San Francisco Marriott
Room Golden Gate A
San Francisco, CA
Wednesday, November 6, 2002
3:30pm- 5:00pm

NAREIT SFO/IR Workshop

The Essex House Hotel
New York, New York
December 2 and 3, 2002
** By invitation only, see page 9*

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NAREIT Activities

Studies Requirements for Re-audits of Prior Period Financial Statements

The SEC has taken the position that, based on Generally Accepted Auditing Standards, when prior period financial statements have been restated or items have been reclassified as discontinued operations and no consent can be obtained from a prior auditor with respect to those prior period statements, the new auditor must reaudit such statements. The combination of the FASB's Statement 144 requirements to report sales of investment properties as discontinued operations, including prior period earnings, and the fact that Andersen is not available to provide a consent covering the filing of prior period financial statements, has created many re-audits among NAREIT member companies.

NAREIT staff has been involved in extensive discussions with member companies and the major audit firms regarding this issue, including a conference call of NAREIT's auditor forum to discuss specific questions raised by member companies. At its September 19, 2002 meeting, NAREIT's Best Financial Practices Council discussed this matter with representatives of the major audit firms. These representatives explained that this is a universal problem and that the major audit firms, together and individually, have petitioned the SEC for relief from this re-audit requirement. We understand that the SEC has not provided, and indicates that it will not provide, any relief in this matter.

Surveys Member Companies' Plans to Expense the Cost of Stock Options

NAREIT staff, along with the Council, have monitored and discussed the current movement in

the broader business/financial arena toward expensing the value of stock options. A number of analyst reports have concluded that this expense is relatively minor for NAREIT member companies. One report indicated that the annual charge would average approximately 1 percent of FFO for the industry. Already, about two dozen REITs have announced that they will begin to expense the value of stock options. This is the preferred, but not required, accounting treatment called for in the FASB's Statement No. 123, *Accounting for Stock-Based Compensation*.

On October 10, 2002, a brief survey was sent to each member company to accumulate information with respect to company plans to begin expensing stock option costs and which method of transition they intend to use.

The results of this survey should be available in November and will be communicated to members.

Implementation of FASB Statement No. 141 for Real Estate Acquisitions

FASB Statement No. 141, *Business Combinations* provides guidance on accounting for business combinations, as well as related guidance on accounting for acquired goodwill and other intangible assets. Many industry participants believe that the application of this guidance requires that, in certain circumstances, in-place leases must be considered intangible assets and, therefore, valued separately from the real estate. There is continuing debate as to the specific circumstances that would trigger the separate valuation of leases.

The threshold question is whether the asset(s) purchased represent a "business" as defined in the Statement. If it is concluded that the transaction represents an acquisition of a business, the consensus conclusion is that below and above

market leases must be valued and accounted for separately from the real estate as intangible assets. Valuing these leases as intangibles would result in recording discounts or premiums as against market rentals related to these leases. The amortization of these discounts and premiums into rental revenue over the life of the related leases would result in future revenues from in-place leases reflecting market rents at the date of acquisition.

NAREIT's Best Financial Practices Council and staff have discussed how these valuations might be completed. The Council and staff will continue to monitor the application of the Statement to acquisitions of real estate and, if appropriate, develop implementation guidance.

Comments on SEC Proposals:

Disclosures About the Application of 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. This proposal was discussed in the July 2002 NAREIT Real Estate Accounting Quarterly which is available in the Accounting issues section of www.nareit.com.

NAREIT's July 19, 2002 comment letter supported the SEC's efforts to improve the transparency of financial disclosures in order to enhance investors' understanding about the application of critical accounting policies, while also addressing certain issues regarding the proposed rules and suggesting changes that would enhance the effectiveness of the required

disclosures. Most important, the comment letter urged that final rules not require companies to provide pro forma earnings information based on alternative principles not utilized by the company. The SEC's proposal is available at www.sec.gov/rules/proposed/33-8098.htm. NAREIT's comment letter is available in the Government Relations section of www.nareit.com. The SEC has not yet issued final rules with respect to this proposal.

Expansion of 8-K Filing Requirements

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 that would require a Form 8-K filing. This proposed rule is available at www.sec.gov/rules/proposed/33-8106.htm.

NAREIT's August 26, 2002 comment letter supported the SEC's efforts to provide investors with enhanced and real-time disclosure of important corporate events. NAREIT agreed with most of the SEC's proposals, but expressed concerns that certain aspects could be counterproductive to the interests of investors and suggested some of the alternative rules and standards that the SEC had outlined in its proposal. In particular, the comment letter strongly urged the SEC to eliminate the proposed requirement for companies to disclose preliminary agreements such as letters of intent. NAREIT's comment letter can be found in the Government Relations section of www.nareit.com. The SEC has not yet issued final rules on this proposal, and NAREIT has scheduled a meeting with the SEC regarding the proposal to report non-binding agreements in a company's 8-K.

Congress Passes Sarbanes-Oxley Act

On July 25, Congress passed the Sarbanes-Oxley Act, which requires dramatic reforms with respect to accounting and corporate governance. Among other things, the Act:

- ◆ Requires CEOs and CFOs to certify periodic reports
- ◆ Creates a public company accounting oversight board
- ◆ Prohibits accounting firms from providing non-audit services to their audit clients without the oversight board's approval
- ◆ Mandates audit partner rotation and establishes a one-year employment restriction on accountants
- ◆ Makes it a crime for issuers to interfere with audits
- ◆ Prohibits corporate loans to directors and executive officers
- ◆ Enhances criminal penalties for a broad range of white collar crimes
- ◆ Makes it a crime to retaliate against corporate whistleblowers.

While many accounting and law firms have provided summaries of the Act, the complete text can be found at www.frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_bills&docid=f:h3763enr.txt.pdf

SEC Activities

Proposes Release on Improper Influence on Conduct of Audits

On October 18, 2002, the SEC issued its proposed rule that would implement Section 303(a) of the Sarbanes-Oxley Act of 2002. The rule would prohibit officers and directors of an issuer, and

persons acting under their direction, from taking any action to fraudulently influence, coerce, manipulate or mislead the auditor of the issuer's financial statements for the purpose of rendering the financial statements materially misleading. The proposed rules are designed to ensure that management makes open and full disclosures to, and has honest discussions with, the auditor of the issuer's financial statements. Further, the rules would specifically prohibit officers or directors of an issuer, or persons acting under their direction, from subverting the auditor's responsibilities to investors to conduct a diligent audit of the financial statements and to provide a true report of the auditor's findings. The proposed release is available at www.sec.gov/rules/proposed/34-46685.htm. The SEC must receive comments no later than November 25, 2002.

NAREIT's Best Financial Practices Council, along with a task force of the Accounting Committee, will review the Proposal and will consider whether to prepare a comment letter. Members wishing to participate in the preparation of NAREIT's comment letter should contact Courtney Lawson at 202-739-9413 or clawson@nareit.com.

Adopts Final Rule on CEO/ CFO Certification of Periodic Filings

On August 27, 2002 the SEC adopted final rules implementing Section 302 of the Sarbanes-Oxley Act of 2002, which requires that CEOs and CFOs deliver personal certifications with respect to financial and other information contained in each annual and quarterly report filed pursuant to the Securities and Exchange Act of 1934. CEOs and CFOs must certify they have reviewed the reports and, to their knowledge, the reports do not contain a material misstatement or omission and

the financial statements fairly present, in all material respects, the company's financial condition, results of operations and cash flows. These executives must also provide certifications with respect to establishing, maintaining and periodically evaluating the effectiveness of a system of disclosure controls and procedures. The complete rule can be found at www.sec.gov/rules/final/33-8124.htm.

NAREIT's comment letter on the SEC's original proposal can be found in the Accounting Issues section at www.nareit.com.

Issues Final Rules on Accelerated Filing

On September 5, 2002, the SEC published final rules that will accelerate the filing deadlines for annual reports on Form 10-K and quarterly reports on Form 10-Q. The new filing deadlines as they would affect most REITs are:

- ◆ Year 2002 10-K's must be filed 90 days after year-end and the three subsequent 10-Qs will be due 45 days after the end of each quarter.
- ◆ Year 2003 10-Ks must be filed 75 days after year-end and the three 10-Qs filed during 2004 are due 40 days after each quarter-end.
- ◆ Year 2004 10-Ks will be due 60 days after year-end and the three 10-Qs filed in 2005 must be filed within 35 days of each quarter-end.

In addition to accelerating filing deadlines, the rules require companies to disclose whether they make their SEC reports available on the corporate websites. The complete rule is available at www.sec.gov/rules/final/33-8128.htm.

Proposes Rules to Require Disclosures on Internal Controls and Financial Experts Serving on Audit Committees

On October 22, 2002, the SEC issued proposed rules implementing Sections 404, 406, and 407 of the Sarbanes-Oxley Act. The proposed rules would require companies to disclose information regarding internal control reports, company ethics codes, and audit committee financial experts in their Exchange Act filings.

The proposed rules specify how companies will have to (1) file with the SEC, as part of their 10-K, an annual report on internal controls that are reviewed by outside auditors; and (2) disclose the number and names of the "financial experts" serving on the audit committee, whether they are independent of management, and if the board of directors determined whether the particular audit committee member is, or members are, financial experts. The complete proposed rule can be found at www.sec.gov/rules/proposed/33-8138.htm.

The SEC must receive comments on or about November 30, 2002. NAREIT's Best Financial Practices Council, along with a task force of the Accounting Committee, will review the proposal and consider preparing a comment letter. Members wishing to participate in the preparation of NAREIT's comment letter should contact Courtney Lawson at 202-739-9413 or clawson@nareit.com.

Preparing Rule on Reporting Pro Forma Financial Information, e.g. FFO

The SEC has recently announced that, pursuant to requirements of Section 401 (b) of the Sarbanes-Oxley Act of 2002, it is preparing a rule to

require companies that publish “pro forma” financial results to explain how they differ from earnings that follow GAAP. Following is the specific legislative language requiring this SEC rule making.

(b) COMMISSION RULES ON PRO FORMA FIGURES -Not later than 180 days after the date of enactment of the Sarbanes-Oxley Act of 2002, the Commission shall issue final rules providing that pro forma financial information included in any periodic or other report filed with the Commission pursuant to the securities laws, or in any public disclosure or press or other release, shall be presented in a manner that

(1) does not contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the pro forma financial information, in light of the circumstances under which it is presented, not misleading; and

(2) reconciles it with the financial condition and results of operations of the issuer under generally accepted accounting principles.

NAREIT’s FFO White Paper recommends that, when FFO is reported, related disclosures should include a reconciliation of this metric to GAAP net income. Further, NAREIT’s comment letter on the SEC’s release proposing accelerated periodic filings recommended this reconciliation requirement. Virtually all REITs regularly provide this reconciliation.

AICPA Continues to Rethink 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 been reviewing its proposal that would establish standards for when costs associated with property, plant and equipment (PP&E) should be capitalized or expensed. Based on AcSEC’s discussions, there has been a shift in the direction of the proposal from what was originally proposed. Shifts relevant to real estate companies include:

- ◆ AcSEC has established the following three overarching principles with respect to the proposal:
 - Assets should be depreciated over their useful lives.
 - Repairs and maintenance programs should be considered in determining useful life.
 - Carrying amount of PP&E should never include costs of duplicate components.
- ◆ Component accounting - A review of the component accounting provisions of the proposal, including what level of detail the proposal intended to require, has led AcSEC members to express concerns about cost-benefit issues resulting from the level of detail proposed. At its September 18 meeting, AcSEC affirmed its conclusion that the degree to which PP&E is componentized should be left to the judgment of management.
- ◆ Composite method of depreciation - AcSEC has concluded that the proposed SOP should not allow the composite method of depreciation because this method would be inconsistent with the principle that the carrying

amount of PP&E should not include the costs of an original component and its replacement.

- ♦ 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.

An area of concern regarding the most recent marked-up 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 proposed 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.

While the current draft of the proposal indicates that this new guidance will be effective in 2004 for most NAREIT member companies, it is possible that it may not be effective until 2005.

NAREIT staff continues to monitor the proposal and deliberations. NAREIT’s comment letter is available in the Accounting Issues section at www.nareit.com.

FASB Actions

Undertakes Limited Fast-Track Project Relating to Stock Option Accounting

The FASB has issued an Exposure Draft, *Accounting for Stock-Based Compensation-Transition and Disclosure*, that would amend FASB Statement No. 123, *Accounting for Stock-Based Compensation*. The amendment would require clearer and more prominent disclosures about the cost of stock-based employee compensation and an increase in the frequency of those disclosures to include publication in quarterly financial statements. Currently, companies are not required to present stock option disclosures in interim financial statements. In addition, the guidance would provide three methods of transition for companies that voluntarily adopt the practice of expensing stock options costs.

The FASB plans to finalize the amendment to Statement 123 by the end of this year and its provisions would be effective immediately upon issuance. The proposed disclosures to be provided in annual financial statements would be required for fiscal years ending after December 15, 2002. The proposed disclosures to be provided in interim financial information would be required as of the first interim period beginning after December 15, 2002, with earlier application encouraged.

A copy of the Exposure Draft is available on the FASB’s website at www.fasb.org/draft/ed_amend_st123.pdf. The comment period concludes on November 4, 2002.

NAREIT's Best Financial Practices Council is reviewing the Exposure Draft.

FASB and IASB Commit to Converge Accounting Standards

At a joint meeting on September 17, 2002 the FASB and International Accounting Standards Board (IASB) agreed to begin eliminating the major differences between their accounting standards and to pursue large rule-making projects together. The Boards set a tentative goal to have the first set of uniform standards worked out by 2005. These universal accounting standards would cover the financial reporting in the United States as well as in 50 countries throughout the world. The ultimate goal of this effort is to achieve greater efficiency in world capital markets.

This agreement could affect the financial reporting of NAREIT member companies in a number of ways. On a philosophical level, standards could establish broader principle-based guidance rather than the detailed rule-based guidance generally found in U.S. standards. This change would allow for more management judgement in applying standards. As a result, disclosures of a particular company's policies and the impact of alternative policies may need to be expanded.

Two impacts of this agreement may be more imminent. First, proposed international standards would require companies to expense the cost of stock options. Since the FASB previously held this view (and provided for this preferred accounting treatment in its Statement of Financial Accounting Standards No. 123) and many companies are moving to this accounting voluntarily, it would seem natural for the U.S. to accept the international rule. Second, the Boards will coordinate their efforts on developing new

standards for reporting comprehensive performance. Early indications suggest that the FASB is leaning toward eliminating all extraordinary items. This would mirror the 1999 change NAREIT made to the calculation of FFO, which requires the inclusion of non-recurring as well as recurring revenue, expenses, gains and losses in the calculation of FFO.

A longer term impact on the financial reporting of NAREIT member companies may be the requirement to report the fair value of investment property either directly in the balance sheet or in notes to the financial statements. This is a current requirement of International Accounting Standard No. 40.

Proposes a Principles-Based Approach to U.S. Accounting Standards Setting

In connection with its global convergence initiative, on October 21, 2002, the FASB issued its proposal, Principles-Based Approach to U.S. Standard Setting (the Proposal). The Proposal discusses how the principles-based approach, as compared to the current rule-based approach to accounting standards, may improve the quality and transparency of financial standards and affect the development and application of future standards.

The full text of the Proposal is available at www.fasb.org/proposals/principles-based_approach.pdf. The FASB requests comments on this proposal by January 3, 2003. NAREIT's Best Financial Practices Council, along with a task force of the Accounting Committee, will review the Proposal and prepare a comment letter over the next two months. Members wishing to participate in the preparation of NAREIT's comment letter should contact Courtney Lawson at 202-739-9413 or clawson@nareit.com.

Makes Progress on Performance Reporting

On October 24, 2001, the FASB added this project to its agenda. The press release states that, “the primary objectives of the project are (1), to improve the quality of information displayed in financial statements so that investors, creditors and others can better evaluate a company’s financial performance. And (2), to ascertain that sufficient information is contained in the financial statements to permit calculation of key financial measures used by investors and creditors.” Over the past six months, the Board has reached a number of conclusions, including:

- ◆ Companies should report all items of revenue, expense, gains and losses in a single statement of comprehensive income
- ◆ Discontinued operations should be reported as a separate line net of income tax effects
- ◆ Extraordinary items should be included in appropriate sections of the statement, possibly defined by broad operating functions, rather than as “below-the-line items.”

The Board’s latest release on this project is available at www.fasb.org/project/fin_reporting.shtml.

NAREIT 2002 SFO/IR Workshop

The Workshop will be held on December 2 and 3 at the Essex House Hotel in New York and will be the first fully integrated meeting available to both financial and investor relation professionals working for corporate members. The program will include three general sessions and eight concurrent sessions providing a broad range of learning experiences. Sessions will cover the new corporate governance and financial reporting environment, the current capital markets and best practices with respect to investor relations. The program is designed exclusively for corporate member financial executives, such as the Chief Financial Officer, Controller, Director of Investor Relation, Treasurer, Vice President of Finance and Chief Accounting Officer. The registration material and hotel information is available at www.nareit.com/members/meetings/sfo2002registration.cfm.

We would like to thank the following sponsors of the Workshop for their continued support of NAREIT events:

- ◆ Alston & Bird LLP
- ◆ BDO Seidman LLP
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If you are interested in sponsoring the Workshop, please contact David Howard, NAREIT’s Director, Member Services & Marketing, at 202-739-9444 or dhoward@nareit.com.

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