Discussion Paper

Accounting for Depreciation of Income-Producing Property

Prepared Jointly By:
National Association of Real Estate Companies
National Association of Real Estate Investment Trusts®

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Summary

The purpose of this Discussion Paper is to generate interest on accounting for depreciation expense from income-producing properties, and is intended to provide a foundation on which accounting standards setters can develop improved financial accounting standards for income-producing properties.

Unlike most depreciable assets, the residual value of an income-producing property generally is significant in relation to its original cost. The estimated residual value of income-producing properties is regularly measured by lenders and investors in connection with transactions that involve income-producing property, including financing, acquisition and disposition transactions. This Paper explicitly endorses the GAAP concept of measuring residual value by allocating the net cost of income-producing real estate to specific reporting periods. This Paper continues the existing GAAP practice of amortizing leasing costs and capital maintenance expenditures as a component of depreciation expense. Many real estate company financial statement users and preparers believe that this refinement of the depreciation calculation would: (1) present a more meaningful representation of financial position; and (2) produce net earnings measurements that are significantly more meaningful in evaluating performance of income-producing real estate. Achieving a meaningful GAAP performance measurement for income-producing real estate would eliminate the need for supplemental performance measurements, and therefore de-mystify REIT financial reporting for investors and lenders not familiar with this unique reporting.

This Paper proposes to measure depreciation using two elements: amortizing the excess of net book value over residual value (salvage value); and amortizing leasing costs and capital maintenance expenditures. Consistent with the existing depreciation accounting model, depreciation cost would be recognized over the useful life of the property or over the life of the improvement in the property. This approach is limited to the calculation of depreciation expense and therefore would not result in a company's balance sheet being increased in the case of an estimate that its properties are worth more than its carrying costs.

A revised approach to accounting for depreciation of income-producing real estate is broadly supported by shareholders, auditors, security analysts, commercial real estate lenders, investment bankers, financial statement preparers and others who evaluate performance of companies that hold income-producing property, particularly those companies holding substantially all real estate assets and whose operations consist of real

estate activities. These companies typically are long-term investors in income-producing properties, such as shopping centers, office buildings, hotels, self storage facilities, industrial properties, health care facilities, and apartment communities.

The approach described herein is consistent with the GAAP concept of measurement of residual or salvage value. Adopting such an approach is not likely to require amending existing FASB statements. Rather it may be considered a practice issue that is specific to depreciation of income-producing property and addressed through the issuance of a Technical Bulletin.

The approach described in this Paper was developed jointly by members of the National Association of Real Estate Companies ("NAREC") and the National Association of Real Estate Investment Trusts® ("NAREIT"). NAREC is a national real estate industry group that represents approximately 100 public and private companies engaged in a wide variety of real estate investment and development activities as well as their associated public accountants and financial advisors. NAREIT is the national, not-for-profit trade association that represents over 250 real estate investment trusts ("REITs"), other publicly traded real estate companies, and over 1,600 accountants, analysts, investment bankers, attorneys and other professionals who provide services to REITs.

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INTRODUCTION
(Paragraphs19-24)[1]

1. In this Discussion Paper, the National Association of Real Estate Companies and the National Association of Real Estate Investment Trusts® are proposing a revised approach to measuring depreciation expense for income-producing properties. This approach would result in a more appropriate allocation of depreciable cost to the operating results of income-producing properties. The real estate industry currently reports "Funds from Operations" (FFO) as a supplemental performance benchmark because existing accounting for depreciation results in net income under generally accepted accounting principles ("GAAP") that is generally not accepted within the investment community as a meaningful performance measure for companies that own income-producing property. This Paper is intended to provide a helpful foundation on which standard setters can develop improved financial reporting standards for income-producing property. It was developed based on the widely-held belief that companies should be evaluated based on performance results that are measured under GAAP.

2. This Discussion Paper determines depreciable cost by using two elements of depreciation: the excess of net book value over residual value[2] of the property; and the amortization of leasing costs and capital maintenance expenditures or the life of the lease or the improvement. Consistent with the existing depreciation model under GAAP, depreciable costs would be amortized over the life of the property or over the life of the improvement in the property.

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[1] Reference paragraphs in Appendix, Basis for Conclusions, provide background information and approaches considered in the development of this Paper.

[2] In the real estate industry, the term "salvage value" that is used in depreciation accounting literature and represents an important component of the depreciation accounting model, is called "residual value," which is better suited to income-producing properties. In this Paper, the terms "salvage value" and "residual value" share the same meaning.

3. This Discussion Paper presents a revised approach to measuring and recognizing depreciation, which is defined in accounting literature as a process of allocation, not of valuation.[3] It is the process of allocating the "cost" of tangible capital assets to expense in a systematic and rational manner to those periods expected to benefit from the use of the asset. The "cost" of the asset is determined by reducing the aggregate, cumulative cost (cost basis net book value) by the estimated amount that would be received when the asset is sold or removed from service (residual value). The Paper does not propose changing existing depreciation accounting methods that *allocate* net costs to the estimated useful life of property. In its definition of depreciation accounting, Accounting Research Bulletin No. 43 states, "depreciation is a system of accounting which aims to distribute costs, less salvage value, over the useful life of the unit in a systematic and rational manner." In practice, depreciation accounting in accordance with ARB 43 has not been applied. This Paper's approach to depreciation accounting is consistent with ARB 43.

4. A revised approach to existing depreciation accounting practice is supported by users of financial statements of commercial real estate companies. Distortions in net earnings has produced a variety of supplemental performance measures unrelated to GAAP in order to provide financial statement users more relevant indicators of economic performance. This subject has been the subject of investor interest and news publications. For example, it was recently stated in an article in the Wall Street Journal, dated October 11, 1996, "Because REITs are real property in equity form, you can't analyze them as if they were shares of a company that manufactures widgets. For instance, net income and earnings are misleading indicators because they reflect depreciation. REIT watchers use a unique measure known as funds from operations,' which measures a REIT's income with real estate depreciation added back." On November 24, 1996, the Washington Post wrote, "For the individual investor, evaluating a REIT stock is a bit different from evaluating other kinds of stock. The most obvious difference is that profit is not the bottom line. That's because net income—profit—is considered an irrelevant measure of performance, even though generally accepted accounting principles require REITs to report it. Instead, analysts focus on something called funds from operations, or FFO." This Discussion Paper explores different approaches to measuring depreciation that would result in a more meaningful and reliable estimate for depreciation and a more accurate measure of performance as reported in net earnings.

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[3] Impairment measurement is a measure of value and is not addressed in this Paper. Income-producing property owners will continue to apply guidance in FASB Statement No. 121 for impairment purposes.

ACCOUNTING FOR DEPRECIATION

Definitions and Scope
(Paragraphs 28-33)

5. In SFAS No. 41, "Financial Reporting and Changing Prices: Specialized Assets—Income-Producing Real Estate," the Board defined income-producing real estate using the following criteria:[4]

    a. Cash flows can be directly associated with a leasing agreement with unaffiliated parties.
    b. The property is being operated. (It is not in a construction phase.)
    c. Future cash flows from the property are reasonably estimable.
    d. Ancillary services are not a significant part of the lease agreement.

    This Paper covers similar properties and is intended to include, for example, office buildings, apartments, warehouses, retail centers, self-storage facilities, industrial properties, health care facilities and hotels. The Scope of this Paper includes only these properties when they are in service to generate income for the company, not when they are for sale or disposition.

6. For purposes of this Paper, depreciable cost consists of two elements: (1) the excess of a property's net book value over its residual value, and, (2) the *capital expenditures required to maintain the usefulness* of a property over its anticipated life, also called "recurring non-revenue enhancing capital expenditures." For example, the first element of depreciable costs will be impacted by the decreased value of the property when the property experiences lower cash flows. The second element includes the cost of maintaining the usefulness of the property (e.g. leasing costs, the cost of installing new roofing, HVAC, and other capital replacements).

7. This approach does not change the fundamental tenets of depreciation accounting-- that is a system of accounting that *aims to distribute the cost or other basic value of tangible capital assets, less residual value, over the estimated useful life of the asset.* It continues to be a system of allocation, not of valuation.

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[4] Similar to the definition of income-producing property under paragraph 6, of FASB No. 41, as amended by paragraph 44, of FASB No. 89, includes all leased properties, not just those subject to a long-term leasing agreement.

MEASURING DEPRECIATION
(Paragraphs 34-40)

8. Depreciable costs for income-producing real estate would consist of two elements and should be calculated by considering each element separately: (1) the costs representing the loss of value from obsolescence, deterioration, etc.; and (2) leasing costs and capital maintenance expenditures necessary to maintain real estate over its estimated useful life. The initial cost basis net book value of the property would include all costs of developing or acquiring the property, which are capitalized under current GAAP. Costs would be added to this initial cost basis only if the capital expenditures result from expansion or reconfiguring the project's space or from major remerchandising, renovation programs that materially enhance the character and fair value of the project.

9. Both elements described in paragraph 8 should be amortized over the remaining life of the property, or in the case of certain leasing costs and capital maintenance expenditures, the life of the lease or the improvement.

Depreciation Based on Residual Value

10. When a property has experienced a decrease in net cash flows which further results in a decrease in the current or expected market price, these changes would be reflected in the residual value of the property. Residual value is defined as the anticipated value of the property at its intended time of disposition. In order to add a measure of conservatism, residual value could not be greater than the fair market value or cost basis net book value at the reporting date.

11. Consistent with existing accounting standards that refer to the use of fair values, the *fair value* of an asset

> is the amount at which the property could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows

using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.[5]

This standard definition of fair value does not mandate the use of outside appraisals or require extensive calculations each reporting period. Noted in existing accounting literature, determining fair value requires judgment and estimates, and the eventual outcomes may differ form those estimates.[6] Companies that own income-producing properties should have the latitude to develop measurement methods that are reliable and practical in their circumstances.

12. Depreciation would occur when the *residual value* of the property is estimated to be less than its net book value. The amount to be depreciated over the property's useful life would be the excess of the cost of the property over the residual value and would be amortized over the remaining useful life of the property.

13. An entity shall review its estimate of residual value whenever events or changes in circumstances indicate that the salvage value has changed. The following are examples of events or changes in circumstances that indicate that the estimate of residual value should be reassessed:[7]

    a. A significant change in the market value of an asset
    b. A significant change in the extent or manner in which an asset is used or a significant physical change in an asset
    c. A significant change in legal factors or in the business climate that could affect the value of an asset or an action or assessment by a regulator
    d. An accumulation of costs significantly in excess of the amount originally expected to acquire or construct an asset
    e. A current period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with an asset used for the purpose of producing income.

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[5] Fair value definition in paragraph 7, FASB Statement 121, "Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of"

[6] Paragraph 9, FASB Statement No. 121.

[7] Similar to circumstances defined in paragraph 5 in FASB No. 121.

Depreciation of Leasing Costs and Capital Maintenance Expenditures

14. Depreciable costs also should include leasing costs and capital maintenance expenditures made to maintain property values and revenue streams. Leasing costs include those costs directly associated with the generation of specific revenues. Examples include tenant improvements, tenant allowances, leasing commissions and related legal fees. Capital maintenance expenditures are costs indirectly associated with the generation of revenue. Examples include replacement of existing components such as roofing, HVAC systems, and parking lot resurfacing.

15. Leasing costs and capital maintenance expenditures would be measured and added to depreciable cost in the reporting period in which the leasing costs and capital maintenance expenditures are made. These costs become an allocated depreciation expense recognized in the earnings statement for each period beginning in that period when the cost is incurred and continuing in subsequent periods over the useful life of the improvement (but not to exceed the remaining life of the property). The allocation of these costs as described here are the same under current GAAP.

DISCLOSURES
(Paragraph 41)

16. Under the approach described herein, companies should disclose the following information either in the body of the financial statements or in the accompanying notes:

    a. The total cost basis of its properties in aggregate, and aggregate depreciable costs.
    b. Explanation of how depreciable costs were determined, including the method for determining residual or salvage value; and the method for amortizing depreciation costs associated with leasing costs and capital maintenance expenditures.

EFFECTIVE DATE AND TRANSITION
(Paragraphs 42-43)

17. The new approach described in this Paper may be made effective for financial statements beginning after a certain year-end as most real estate companies report on a calendar year basis. It should be applied on a prospective basis, and earlier application should not be allowed. Financial statements from prior periods included for comparative purposes should be presented as previously reported.

    A change in depreciation expense arising from a change in *residual value* estimate is considered a change in accounting estimate and should be accounted for in the period of change and future periods if the change affects both. Changes in an estimate should not be accounted for by restating amounts reported in financial statements of periods prior to adoption or by reporting pro forma amounts for prior periods.

Appendix A

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

19. This appendix summarizes considerations that were deemed significant in reaching the conclusions in this proposed approach. It includes reasons for accepting certain approaches and rejecting others.

20. In August 1995, several commercial real estate professionals who are members of the National Association of Real Estate Companies ("NAREC") and the National Association for Real Estate Investment Trusts® ("NAREIT") met with a Board member and staff to discuss certain financial issues unique to accounting for income producing property. In that meeting, Board staff considered the problems presented and encouraged representatives from NAREC and NAREIT to explore and develop an alternative approach to depreciation for income-producing properties. This Discussion Paper incorporates the results of subsequent discussions among industry members, accounting practitioners, financial analysts and investment banking professionals. It is intended to further discussions that were initiated in 1995, and provides a foundation for the Board's initiation of a project to address the measurement of depreciation for income-producing properties.

21. New approaches that enhance the usefulness of financial statements are consistent with standards setting goals and described in FASB Statement of Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises," which includes the following among the broad objectives of financial statements:

> Financial reporting should provide information to help present to potential investors and creditors and other users in assessing the amounts, timing and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. The prospects for those cash receipts are affected by an enterprise's ability to generate enough cash to meet its obligations when due and its other cash operating needs, to reinvest in operations and to pay cash dividends and may also be affected by perceptions of investors and creditors generally about that ability, which affect market prices of the enterprise's securities. Thus, *financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprises.*

22. The real estate industry and virtually all users of its financial statements believe that the application of depreciation methods currently used in accounting for income-producing properties result in periodically reported net income that does not adequately aid in the assessment of the amounts, timing, and uncertainty of prospective net cash inflows to enterprises in the business of owning and operating such properties. This position was substantiated by a survey completed by Coopers and Lybrand as part of the FASB's evaluation of the usefulness of current cost/constant dollar reporting. The survey of lenders and equity analysts regularly associated with income-producing real estate concluded that (1) the disclosure of current cost/constant dollar information was not useful, and (2) operating cash flow and value information related to these properties was needed. There was no indication that GAAP net earnings provided relevant information. Separately, one analyst asserted that depreciation is a stumbling block to an effective understanding of investments in entities that own and operate income-producing real estate.

23. Unless GAAP is modified, financial statement users and public companies that own and operate income-producing real estate will continue to use supplemental performance measures to provide financial statement users more relevant indicators of profitability. In 1991, NAREIT adopted a uniform performance measure called "funds from operations" ("FFO"), which analysts currently examine as an alternative to net income. FFO excludes historical cost depreciation from the calculation of net income under GAAP. FFO has become an accepted industry benchmark for gauging operating performance of real estate companies. For example, the First Call estimates of real estate companies' earnings are based on FFO rather than net income. Multiples are applied to FFO per share to develop market pricing for the shares of these companies.

24. Some financial statement users advocate the use of "Adjusted Funds From Operations" (AFFO) as a superior measure of performance for companies that own income-producing properties. AFFO attempts to include a variety of costs related to leasing and maintenance of a real estate portfolio. By including capital maintenance improvements as a component of depreciable cost, the approach discussed in this Paper is more closely in line with AFFO. It has the advantage of producing an appropriate GAAP net income amount that would be more widely accepted by the investing community than any supplemental measurement.

Benefits and Costs

25. Standards setters may need to determine that a new approach will fill a significant need and that the cost it imposes, compared with possible alternatives, will be justified in relation to the overall benefits. When conducting cost/benefit analysis, standards setters should

take into account that existing methods for depreciation have penalized real estate companies in the broader capital markets.

26. The reported cost of equity will become more reliable based on the approach presented in the Paper because the investment community would have a more reliable earnings per share measurement for real estate companies that is comparable to measurements used to evaluate investments in other industries. Consistency across industries in measuring equity would provide real estate companies a level playing field to compete with other industries in the capital markets and reduce their cost of capital.

27. An existing burden to financial statement preparers in companies with income-producing real estate involves the additional preparation of alternative performance indicators to measure economic performance that is separate from net income under GAAP. The direct and indirect costs of maintaining, reporting and explaining alternative measures of performance are sizable.

Definitions and Scope

28. The Scope was initially limited to address real estate, and exclude other depreciable assets. The treatment of real estate in determining depreciation needs to reflect certain intrinsic value present in all real property that is not present in other depreciable assets:

    a) Land and improvements to land are two apparently distinct components that are intrinsically related. Income generated from the lease, sale or rent of real property is based on the aggregate of these two components;

    b) Resale value is usually significant in amount in relation to the cost basis carrying value of the property and may even exceed the carrying value.

    c) The actual useful life of real estate is usually much longer than depreciation schedules allow-- typically 20 years and beyond.

    d) Real estate is less susceptible to obsolescence.

    The Scope then was narrowed to income-producing property and expressly excludes other types of real estate. This was done when several noteworthy characteristics are considered that distinguish other real property from income-producing property, such as property that is used to house production or to provide administrative office space for the activities of a company. When examining income-producing real estate, the following benefits are present:

a) the direct attribution of cash flows to each property and the relative predictability of net revenue streams as demonstrated by typical financial arrangements and efficient pricing in an active real estate market;

b) economic analysis of an income-producing property focuses on the discounted amount of expected future cash flows;

c) having a value that is usually not realized through immediate sale; its economic benefits, including the recovery of its cost, usually are realized over an extended number of years through cash flow from rental operations and ultimately through the sale of the asset;

d) being a discrete and autonomous economic unit with a distinct tenant and leasing profile and reasonably estimable and discrete net revenue contribution.

30. The use of *residual value*, that is the anticipated value of the property at its disposal time provides a better measure of the true economic costs associated with the revenue streams to be produced. This is based on a widely-held and reliable understanding that depreciation cost based on obsolescence is inherent in the selling price of a property, or in the anticipated future cash flows that are generated from market lease rates.

31. The confidence in the efficiency of values based on net realizable value or the estimated future value is demonstrated when commercial real estate lenders provide financing based on an evaluation of the property's projected income stream (future estimated value). The fair value of a property is readily estimable as a continuous exchange of income-producing properties exists, which provides realistic factors used to value properties. Fair values are a credible and widely accepted means of determining value as they are employed when valuing collateral in highly leveraged transactions with nonrecourse mortgage debt, and secured only by the property and an assignment of its rents.

32. The definition for depreciation accounting as a system of accounting that allocates costs is one that is drawn from existing accounting literature. Where possible, the proposed methodology in the Discussion Paper draws from existing practices and draws analogies based on similar asset characteristics.

33. Capital maintenance expenditures arguably could be included in the cumulative cost basis under the position that all costs associated with a property contribute to its revenue generating capacity and therefore contribute to its residual value. By the same token, measuring depreciable costs by comparing all cumulative costs that are capitalized to *residual value* seemed radical as it could result in never charging operations for depreciation costs, which would be the consequence of the estimated future value consistently

exceeding net book value. Accordingly, this proposal separates all costs of leasing and ongoing capital maintenance expenditures and allocates these costs over the lease term or useful life of the capital improvement.

Measuring Depreciation

34. For the reasons noted in paragraphs 35-39, the approach to measuring depreciation became a two part process. Cost is the net book value, which is the recorded capital investment in the property, and residual value is the anticipated value of the property at its intended time of disposition. This seems to be a conservative and logical approach to incorporating market efficiencies in measuring depreciation.

35. Recording capital maintenance expenditures as a component of depreciation has two benefits: 1) it ensures that measuring depreciation cost addresses what has been contributed to the property to maintain its income earning value; and 2) it ensures that the net book value of the property includes capitalized improvements. Proper management of capital can be assessed by comparing the fair value of a property at acquisition or future estimated fair value to the net book value. Such a comparison can reveal whether management has intelligently invested its capital resources in a manner in which the market will reward by generating sufficient returns.

36. When determining values that rely on estimates, it is important for companies to have a certain degree of latitude to employ methods that are appropriate given the unique market and risk circumstances and other variables that influence the value of income-producing real estate. At the same time, value determinations must be consistent with methods and factors used in the active real estate lending and exchange market.

37. As this approach does not modify the existing method of recognizing depreciation costs, most discussions about recognition involve the timing in which the costs would be recognized, particularly on subsequent appreciation in value, and capital expenditures.

38. When the estimated future value (residual value) falls below net book value, depreciation cost is measured and recognized by amortizing the difference over the remaining useful life of the property. Should the estimated future value increase subsequent to recognizing a depreciation cost, the question was raised of how and whether the subsequent change in residual value should be recognized-- as a reduction in prior depreciation cost, with an attendant adjustment to earnings and/or to equity. Discussions resulted in mixed views and therefore no conclusion is presented in this Paper.

39. Capital maintenance expenditures occur when obsolete or worn elements need replacing. These expenditures are added to the property's cost and would be amortized in accordance

with the periodic allocation from that point in time over future periods determined by the estimated useful life of the capital improvement.

40. Depreciation costs should be amortized as required under existing accounting principles and practices. Limited consideration of when costs would be expensed generated concerns that a new approach to measuring depreciation should not altogether change the accounting for depreciation. The approach described in this Discussion Paper is not intended to change GAAP.

Disclosures

41. The approach requires disclosure to understand carrying values and the means by which those values are determined. Adequate disclosures generate broader acceptance and understanding by the financial statement user community.

Effective Date and Transition

42. The change in measuring the depreciable cost and depreciation expense proposed by this paper represents a change in accounting estimate. Under that characterization, the effect of the change in accounting estimate should be accounted for in the period of changes and future periods if the change effects both.

43. The accounting approach described in this Paper should be adopted for calendar year reporting following the issuance of new measurement guidance.

Appendix B

EXAMPLE

Accounting for depreciation of income producing property is illustrated in the following example:

44. At the time of completion of Building A, the real estate company paid $25 million for the property. The property cost is booked at $25 million and is carried at that value as of that date as follows:

($ in 000's)	19X1
Real Property	25,000

If the real estate company estimates that, based on the planned capital maintenance expenditures and the property's residual value, the estimated net proceeds to be received at the projected sale date of the property will not be less than the $25 million purchase price, then at this point in the example (prior to subsequent events presented below), there is no depreciation expense related to the property.

Leasing Costs and Capital Maintenance Expenditures

45.

A. In the first year of ownership, the real estate company spends $50,000 to lease the property to three tenants. The leasing commissions, tenant improvements, and legal expenditures for the first tenant signing a 5-year lease amount to $25,000. The second and third tenants sign three year leases, each costing $12,500.

B. At the end of the first year, the tenants complain that the existing HVAC systems are inadequate to properly heat and ventilate the building. Real estate company replaces the existing system at a cost of $150,000, with a suitable system that is expected to last 15 years. This capital maintenance expenditure is capitalized and amortized over its estimated useful life of 15 years. The depreciation expense for each annual reporting period is $10,000.

These leasing costs and capital maintenance expenditures would be amortized as follows:

($ in 000's)	19X1	19X2	19X3	19X4	19X5
Leasing Expense					
Tenant #1	5	5	5	5	5
Tenant #2	4.1	4.1	4.1		
Tenant #3	4.1	4.1	4.1		
Capital Exp.-HVAC	0	10	10	10	10
Ttl. Depreciation	13.2	23.2	23.2	15	15

Determining Residual Value

46. At the end of 19X5, the property undergoes major renovation. The real estate company invests $5 million and compares its new cost basis of $30 million to the increased residual value of the property.[8] Fair value as of the balance sheet date is $28 million although the real estate company is anticipating the value to be substantially greater in the future in order to justify the expenditure. The real estate company therefore has depreciation costs of 2.0 million (30.0 - 28.0). Because the property has an estimated useful life of twenty more years, depreciation is reported as a $100,000 per year expense over the next twenty years.

[8] Consistent with a circumstance described in paragraph 13, item b.

47. At the beginning of 19X6, real estate company spends a $50,000 in leasing costs and tenant improvements for Tenant #5's lease of the entire newly renovated Building A for 5 years. Depreciation expense in 19X6 along with the prior years (for illustrative purposes only) are shown below:

	Depreciation Expense					
($ in 000's)	19X1	19X2	19X3	19X4	19X5	19X6
Tenant #1	5	5	5	5	5	
Tenant #2	4.1	4.1	4.1			
Tenant #3	4.1	8.2				
Tenant #4		3	3	3	3	
Tenant #5		10				
Capital Exp.-HVAC	0	10	10	10	10	10
Property Depreciation						100
Total Depreciation	13.2	30.3	22.1	18	18	120