NAREIT

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From the Council

In its effort to enhance the quality and effectiveness of industry financial practices, the Best Financial Practices Council continuously reviews issues related to financial standards and reporting, including the industry's supplemental performance measure. Several issues related to the calculation and reporting of Funds From Operations (FFO) arose during last year's review, or have been forwarded to the Council by NAREIT members. The following guidelines represent conclusions reached by the Council on these issues.

FFO Guidelines

Effective Date of Clarification

As detailed in the November 8, 1999 National Policy Bulletin, the clarification to Funds From Operations (FFO) approved by NAREIT's Leadership was effective January 1, 2000. The question has been raised as to whether the effective date applied to years beginning or ending on or after January 1, 2000. The Best Financial Practices Council's recommendation intended to have the clarification be effective in the first quarter of 2000 for calendar-year companies. Therefore, the effective date of the clarification is "for all periods beginning on or after January 1, 2000."

Early Adoption of Clarification

The Council recently reviewed the implications of discretionary early-adoption of the clarification and concluded that for the benefit of consistency and comparability within the industry, early adoption of the FFO clarification is not encouraged. If companies wish to present periods prior to the effective date in accordance with the clarification, the Council recommends that they should supplementarily disclose the impact of adopting the new rule in the early period - not as the primary presentation or measure.

Gains And Losses From Pre-Sale Agreements

Some affiliates of REITs are involved with the development and sale of property upon completion or stabilization. The question has been raised as to whether the gains or losses from property sold subject to a pre-sale agreement should be included or excluded from the calculation of FFO. The Council recommends that these gains or losses should be treated in accordance with Section III.E., *Gains and Losses on Property Sales*, of the White Paper on Funds From Operations. As provided in the White Paper, companies that choose to include such gains or losses in FFO should disclose the amount of such gains or losses for each applicable reporting period. Those that do not, should address the amount of such gains or losses in their reconciliation of net income to FFO.

Calculating and Reporting FFO

During its review of the industry's supplemental performance measure in 1999, the Council noted that when some companies calculate FFO, they have adjusted net income for items that are not included in net income under generally accepted accounting principles (GAAP). The Council has concluded that only items included in GAAP net income (and specified as adjustments in the FFO White Paper) should be included when adjusting net income to calculate FFO.

An example of an item that is not in GAAP net income but is being included in the calculation of FFO is the addition to net income of the portion of the lease payments received for the imputed principal payments under the terms of a direct financing lease (FASB 13). When real estate assets are classified as "direct financing leases" under FASB 13, the imputed principal portion of the lease payments received is charged directly to the asset (receivable) on the balance sheet, rather than being recorded as revenue.

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Another example is the addition to net income for the expense related to dilutive potential common shares. When companies report FFO, the Council recommends that to be consistent with how companies calculate and report net income under GAAP, FFO should be calculated before the impact of the expense add-back related to dilutive potential common shares (i.e., convertible securities such as bonds, preferred stock, and UPREIT or DownREIT units). When a company reports FFO after adjusting for the expense related to dilutive potential common shares, FFO should be labeled "diluted."

SEC Rulemaking

Selective Disclosure Rules Proposed; NAREIT Task Force Formed

NAREIT is forming a Selective Disclosure Task Force to prepare an industry response to the Securities and Exchange Commission's (SEC) proposed rules, Regulation FD (Fair Disclosure), that addresses the practice of "selective disclosure." The SEC is concerned with the release of material information to selected individuals - generally analysts and large investors - before release to the general public and the media, whereby the selective release of such information puts individual investors at a disadvantage. The proposal would require that intentional disclosure of material information must be made through public disclosure. Once an issuer learns that it has made a non-intentional material selective disclosure, it must make prompt public disclosure of that information either by filing the information with the SEC, issuing a press release, or providing public access (e.g., via phone or internet) to a conference call or meeting. The proposal also will seek to clarify insider-trading issues.

There is a 90-day comment period ending on March 29, 2000. Anyone interested in participating in NAREIT's task force should contact Anna Chason at (202) 739-9415 or achason@nareit.com, or David Taube at (202) 739-9442 or dtaube@nareit.com.

Staff Accounting Bulletin on Contingent Rents Issued

On December 3, 1999, the SEC issued Staff Accounting Bulletin No. 101 (SAB), *Revenue Recognition in Financial Statements*, summarizing the staff's views in applying GAAP to revenue recognition in financial statements. Included in the SAB is the staff's resolution of the accounting for contingent rental income by lessors under operating leases. In its interpretive response to Question 8 of the SAB, the staff indicates that, "contingent rental income 'accrues' (i.e., it should be recognized as revenue) when the changes in the factor(s) on which the contingent lease payments is (are) based actually occur."

In other words, contingent rental income can only be recognized as income once the contingency has been satisfied. For companies that must change their practice, this treatment will lower the earlier quarters' earnings (and FFO), thereby postponing to a later period the recognition of income. Sectors generally more affected by this change include hotel, retail, and health care. However, the SAB will not affect the earnings (and FFO) of these companies on an annual basis when the contingencies normally are resolved by the end of the year.

To transition to the accounting described in the SAB, NAREIT has confirmed with the SEC staff that a change to reflect the staff's view of accounting for contingent rental income would be accounted for as a cumulative effect of a change in accounting principle pursuant to APB 20. This transition should be accounted for no later than the first fiscal quarter of the fiscal year beginning after December 15, 1999.

Please see the Accounting Issues section of the "Members only" part of www.nareit.com for NAREIT's National Policy Bulletin titled *"SEC Resolves Accounting for Contingent Rental Income."* The SAB can be found at http://www.sec.gov/rules/acctreps/sab101.htm.

Staff Accounting Bulletin on Restructuring Charges Issued

Furthering SEC Chairman Arthur Levitt's commitment to clarify staff views on various issues, on November 24, the SEC issued Staff Accounting Bulletin No. 100 which emphasizes the criteria that must be met before restructuring charges may be accrued. The SAB states that excess or unused accrued amounts beyond those permitted by existing GAAP should be reversed in a timely manner. It also emphasizes the criteria under GAAP that must be met prior to recognizing an impairment charge related to long-lived assets and other intangible assets. Lastly, the SAB provides the staff's views on the measurement of liabilities and other loss accruals assumed in a purchase business combination. The entire SAB can be found at http://www.sec.gov/rules/acctreps/sab100.htm.

Audit Committee Rules Adopted

The SEC has issued final rules and amendments with respect to Audit Committee disclosures in certain SEC filings. These rules and amendments are primarily based on recommendations made by the Blue Ribbon Committee on Improving the Effectiveness of

Corporate Audit Committees (Blue Ribbon Committee). In addition, the SEC approved changes to listing standards proposed by the NYSE, NASDAQ and AMEX, as well as the AICPA Auditing Standards Board's (ASB) proposed amendments to Statements on Auditing Standards Nos. 61 and 71; all in response to the Blue Ribbon Committee recommendations. This article summarizes these broad rule changes. The entire SEC release can be reviewed at www.sec.gov/rules/final/34-42266.htm.

NAREIT submitted comment letters to both the SEC and ASB in response to their proposals. These letters are available in the "Members only" section of www.nareit.com.

The SEC adopted these new rules and amendments to improve disclosures relating to the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements of public companies. A reason cited for these new rules is the increased pressure on companies to meet quarterly and annual earnings projections. The SEC believes this burden highlights the importance of the financial reporting process to remain disciplined and credible. The new rules require that:

- companies' independent auditors review the financial information included in the companies' quarterly 10-Q filings prior to filing;
- companies include reports of their audit committees in their proxy statements indicating that the audit committee has:
  - reviewed and discussed the audited financial statements with management;
  - discussed with the independent auditors matters required to be discussed by Statements on Auditing Standards No. 61;
  - received disclosures from the auditors with respect to, and discussed with the auditors, the auditors' independence; and
  - recommended to the Board of Directors that the audited financial statements be included in the company's annual 10-K filing.
- companies disclose in their proxy statements whether their Board of Directors has adopted a written charter for the audit committee, and, if so, include a copy of the charter in the proxy statements at least every three years.

These new rules and amendments are effective for fiscal quarters ending on or after March 15, 2000, and for all proxy and information statements relating to votes of shareholders occurring after December 15, 2000.

The final rules reflect a number of notable changes from the SEC's original proposal. First, the auditor's review of quarterly financial information is not required to be completed before the information is released to the public if the release is prior to the 10-Q filing. Second, the new rule does not require that audit committees state whether anything has come to its attention that caused the committee to believe that the audited financial statements contain an untrue statement of material fact or omit to state a material fact necessary to make the financial statements not misleading.

The American Institutute of Certified Public Accountants (AICPA) has not yet published final amendments to Statements of Auditing Standards Nos. 61 and 71. These amendments are expected to be available before the end of January.

SEC Issues Audit Risk Alert Topics

In its second annual letter to the AICPA highlighting Audit Risk Alert topics, SEC Chief Accountant Lynn Turner reiterated that registrants are expected to follow the guidance in recently issued Staff Accounting Bulletins (SAB), including SAB No. 99, *Materiality*, SAB No. 100, *Restructuring and Impairment Charges*, and SAB No. 101, *Revenue Recognition in Financial Statements*.

Of note to real estate companies were the comments related to Segment Disclosures (FASB 131). The letter indicates that the SEC staff has seen instances when there is a lack of consistency between the segment information provided in the MD&A or press releases and the data included in the financial statements (including the footnotes). As part of its normal review and comment process, the staff requests registrants to provide the material given to the company's "chief operating decision maker." If there is a lack of consistency between the segment information in the financial statements and the company's internal reports, "the staff will request registrants to amend the financial statements."

Finally, Mr. Turner reminded companies that the SEC recently implemented new policies and procedures to improve the pre-filing process. The *Protocol for Registrant Submissions to the Office of the Chief Accountant* is available on the web at www.sec.gov/offices/account/acproreg.htm.

IASC Proposes "Free Choice" on Investment Property Accounting

At its December meeting, the International Accounting Standards Committee (IASC) agreed to move ahead with the development of a standard that permits a "free choice" between fair value and historical cost reporting for investment property. Significantly, companies that choose the historical cost basis (IAS 16, *Property, Plant and Equipment*) would be required to provide a footnote disclosure of the fair value of investment property.

Further, the accounting model chosen would be required to be applied on a company-wide basis, not by individual property or groups of properties. In addition, investment property under construction would be measured at cost.

With this move, the IASC hopes that preparers and users of financial statements will become accustomed to accounting and reporting for investment property on a fair value basis. A vote on a final standard is expected to occur in March of this year.

NAREIT's Investment Property Task Force supported the direction of the IASC, but indicated in its October 29, 1999, comment letter that there are certain issues that must be more fully investigated before the industry would be a proponent of adopting fair value accounting for investment property in the US. Similarly, the Financial Accounting Standards Board's staff comment letter to the IASC generally agreed "with moving toward a fair value reporting model for investment properties," but had concerns with the proposed standard as drafted. Notwithstanding these concerns, the FASB staff "believe[s] that fair value may result in the most relevant information for an investment property," with the fair value reporting model being "more relevant than historical cost."

Offering an opposing view, the Accounting Standards Executive Committee (AcSEC) of the AICPA disagreed with the basic premise of the proposal that investment property should be measure at fair value. Instead, AcSEC believes that the historical cost model prescribed in IAS 16 should apply. The basis for this opinion included a belief that investment property is not similar to financial instruments for which there exists an exchange market. They also disagreed with the notion that a company will be able to determine fair value reliably and consistently, and expressed concern about the cost of obtaining fair value information for each reporting period.

FASB Readies Issuance of Employee Stock Options Rules

On January 12, a majority of the Financial Accounting Standards Board (FASB) preliminarily voted to issue by March 31 its interpretation of APB Opinion No. 25, *Accounting for Stock Issued to Employees*. A dissenting minority is concerned with the Board's decision to include outside directors under the advantageous accounting provisions of APB 25. This decision represented a reversal of the position outlined in the original proposal. The Board also decided that a re-exposure of the pending interpretation was not warranted.

On other issues to be included in the final interpretation, the FASB reaffirmed or reached the following decisions:

- Repricings date - The December 15, 1998 effective date in the original proposal will apply to any stock award or repricing occurring after that date. As proposed, repricings would trigger variable-plan accounting and recognition of compensation expense. However, recognition of compensation expense would not be required until after the final interpretation is issued. The date was selected to prevent options repricings and other actions that would circumvent the proposed interpretation.
- Synthetic repricings - The provisions applicable to regular repricings also would apply to synthetic repricings. Under a synthetic or indirect repricing, the recipient of an award or option can profit from its exercise even though the share price is below the share price set at the time the grant was made.
- Replacement options - Cancellation of a fixed stock option and the issuance of a lower-priced option within six months before or after the cancellation would be considered a reissuance and lead to variable plan accounting. Considered to be a repricing, the December 15, 1998 effective date provisions also would apply to replacement options. A decoupling of the cancelled and newly issued award would occur if the new issuance was made outside of the six-month window.
- Modifications - Indirect or direct changes to the exercise price and number of shares would not lead to a new measurement date, but would result in variable plan accounting and recognition of compensation expense. An indirect or direct change to the term of the stock award or option agreement (e.g., accelerated vesting or the extension or renewal of the option term) would lead to a new measurement date, as well as the recognition of compensation expense.
- Options reloads - Stock option reloads provide for automatic grants of added options when an employee exercises previously granted options using shares, rather than cash, to meet the exercise price. The modification of a fixed stock option award with the addition of a reload feature that is activated by the original grant would lead to variable plan accounting (compensatory) from the date of the modification. This provision will have an

effective date of January 12, 2000. Reload features included in the original terms of an award would still be accounted for as a fixed plan (non-compensatory).

FASB Releases Preliminary Views on Fair Value Accounting for Financial Instruments

In December, the FASB issued its Preliminary Views on measuring financial instruments at fair value, the next step in a potential move toward comprehensive fair value reporting of all financial assets and liabilities. The preliminary views cover three core issues: 1) What would be reported at fair value; 2) What is fair value; and 3) How would changes in fair value be reported.

Fair value of a financial instrument would be its estimated market exit price (i.e., the price at which an instrument could be sold). The document defines financial instruments as:

- Cash;
- Ownership interest in an entity;
- Contractual obligations to deliver financial instruments to another entity and that entity's contractual rights to receive them; and
- Contractual obligations for one entity to exchange financial instruments with another and the second entity's contractual rights to require the exchange.

For real estate companies, the financial instruments covered by the Preliminary Views report would be applicable to the financial assets and liabilities shown on consolidated and individual company balance sheets prepared in accordance with GAAP. Excluded from the Preliminary Views report are "investments in consolidated subsidiaries" and "investments in unconsolidated subsidiaries" accounted for under the equity method of accounting when these investments are reported as assets on the balance sheet.

During its review of the issue, the FASB will consider whether to require changes in fair value to be reported in net income or enhanced disclosures. Although the FASB believes there are conceptual reasons to measure financial instruments at fair value, through the exposure of its preliminary views it will seek information on the practical issues of reporting financial instruments at fair value.

The preliminary views are available on the web at www.rutgers.edu/Accounting/raw/fasb/new/index.html, or from the FASB Order Department at (800) 748-0659. The comment letter deadline is May 31, 2000. NAREIT will be discussing this issue with its Accounting Committee and other NAREIT members to determine whether the formation of a task force and response is warranted. If you have any comments, please contact David Taube at (202) 739-9442 or dtaube@nareit.com.

NAREIT Submits Industry Response to FASB Business Combinations Proposal

In November 1999, NAREIT formed a task force to respond to the FASB's exposure draft on Business Combinations and Intangible Assets. The proposal would prohibit the pooling-of-interests method of accounting for business combinations, but would require that companies report on the face of the income statement their earnings, including per-share amounts, both before and after goodwill amortization. The comment letter submitted by NAREIT's Business Combinations Task Force supported the proposal and noted the direct similarities between goodwill and its amortization, on the one hand, and investment property and its depreciation, on the other. The comment letter further stated that these similarities suggest that the FASB should develop a financial disclosure practice that would permit real estate companies to isolate investment property depreciation from other operating expenses on the income statement. This would allow an earnings subtotal (absolute and per share) before depreciation. NAREIT's comment letter can be found in the Accounting Issues section of the Members Only section of www.nareit.com.

NAREIT Reconvenes Derivatives and Hedging Task Force

NAREIT is reconvening its Derivatives and Hedging Task Force to assist real estate companies prepare to adopt the FASB's new derivatives accounting standard, SFAS No. 133, which becomes effective for fiscal years beginning after June 15, 2000. Under the new standard, real estate and other companies that commonly hedge interest rate risk will be forced to mark-to-market all hedges and record them on the balance sheet, and in many cases report certain market value changes in earnings.

The standard requires that each company using hedges to manage interest rate and other risks to develop a specific hedging policy that defines interest rate risk-management strategies and includes quantitative parameters for establishing what is an acceptable hedge. Without a policy in place that includes these parameters, all hedges will be marked to market through earnings. All hedges must be designated with written documentation as either fair value or cash flow hedges - types of hedges that are defined in the standard. The standard also requires that the designations include a description of the hedging transaction, and indicate how the hedge and the hedged item will be measured for effectiveness on an ongoing basis.

The task force will identify accounting policy issues producing results that do not portray the economic implications of common real estate company hedging transactions and raise these issues with the FASB's Derivatives Implementation Group prior to the standard's effective date. The task force also will identify implementation issues and provide guidance to NAREIT members. Finally, the task force will consider developing a recommended industry policy/practice to adopt the standard. Anyone interested in participating in NAREIT's task force should contact David Taube at (202) 739-9442 or dtaube@nareit.com.

NAREIT Task Force Submits Comments on Asset Componentization to AICPA

NAREIT formed a Cost Capitalization Task Force last August to provide input to an AICPA/AcSEC project as it develops an accounting standard [Statement of Position (SOP)] that would distinguish which expenditures related to real estate should be capitalized or expensed. NAREIT's task force recently submitted comments to the AICPA Task Force related to the pros and cons of asset componentization. This letter, which is available in the "Members only" section of www.nareit.com, suggests that the attention and focus on the primary purpose of the AcSEC task force (i.e., what costs should be capitalized) should not be diluted by the componentization question. By focusing on the development of guidelines for the capitalization of certain items considered to be "gray areas," comparability within the industry could be enhanced.

NAREIT's Task Force also forwarded its opinion that the AcSEC task force should not consider componentization of the costs of investment property unless it is prepared to evaluate the depreciable lives of the components. Componentizing the costs without considering the depreciable life of each component may exacerbate the overstatement of investment property depreciation expense.

Finally, NAREIT's Task Force also suggested that the AICPA task force should consider that the International Accounting Standards Committee (IASC) is moving toward an investment property model with less componentization than currently exists under the historical cost model now used under U.S. GAAP. The IASC is considering fair value accounting for investment property that would combine land and building into one component. This suggests that now may not be the time to consider additional componentization since the international model is heading in the opposite direction.

NAREIT Y2K Meetings Schedule

Mark your calendar for this year's meetings schedule. The Law & Accounting Conference will be held on May 17-19 at the Doral Golf Resort & Spa, Miami, Florida. The Annual Convention is set for October 2-4 at The Washington Hilton and Towers, Washington, D.C. The Accounting Committee will meet on the afternoons of Wednesday, May 17 and Monday, October 2. The fourth annual CFO Workshop heads west to Chicago on November 13 and 14 at the Westin O'Hare. Program information on each event will be distributed in upcoming months. If you have any questions, please contact Catherine Kaempffer at (202) 739-9427 or ckaempffer@nareit.com.

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