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NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS

SFO Alert (February 13, 2015)

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SEC AREAS OF FOCUS IN REVIEWING 2014 10-K FILINGS

Through informal conversations with the Staff of the Division of Corporation Finance of the Securities and Exchange Commission (the Staff), NAREIT has identified potential areas of financial reporting that the Staff may focus on in their review of 2014 real estate company (including REITs) 10-K filings. The areas identified in this alert do not impose new disclosure requirements and they are not intended to limit the areas of potential Staff comments. Please remember Staff comments will depend on the facts and circumstances of a particular company.

General Items

Disclosure Effectiveness

The SEC's Disclosure Effectiveness Project is a division-wide initiative that is intended to review the disclosure requirements included in Regulation S-X and Regulation S-K. The SEC is considering ways to modernize disclosures to facilitate timely, material disclosure by registrants and continue to provide decision-useful information to investors. The Staff reminds registrants to consider this initiative as they prepare 10-K disclosures. Key aspects of the disclosure effectiveness initiative include actions that registrants can take today with respect to preparing 2014 Form 10-Ks. They include:

- Reduce repetition;
- Use hyperlinks;

- Use charts if this can convey information more effectively;
- Tailor disclosures to the reporting entity and specific facts and circumstances;
- Eliminate outdated disclosure or disclosure for items that are no longer considered material; and,
- Do not automatically add disclosure when the Staff requests supplemental information.

Staff requests for supplemental information do not automatically need to be disclosed in the document. The Staff encourages registrants to gather the information requested, and then have a dialog with the Staff before revising disclosure.

Non-GAAP Financial Measures

The Staff reminds registrants that non-GAAP financial measures that are included both inside and outside of Form 10-K are subject to Staff review. This would include the earnings release, the transcript of the earnings conference calls, supplemental information that is furnished as exhibits in Form 8-K, company websites and company press releases.

If the non-GAAP financial measure is considered a key performance indicator (KPI), it should be included in the Form 10-K, accompanied by appropriate disclosures required by Item 10(e) of Regulation S-K. If the non-GAAP financial measure is not considered a KPI, but the registrant still has reason to disclose it outside of its filings, it should be presented and reconciled to the most closely related GAAP measure in accordance with Regulation G.

Regardless of whether a non-GAAP financial measure is included within or outside of a filing, it should be clearly labeled. For example, when registrants use NAREIT Funds From Operations (FFO) and Adjusted Funds From Operations (AFFO) as KPIs, they should clearly label such measures, which can be done by reconciling AFFO through NAREIT FFO.

Rule 3-14 Financial Statements

The Staff continues to answer questions regarding the updated interpretative guidance with respect to the application of Rule 3-14 published in the Division of Corporation Finance Reporting Manual and this will continue to be a focus area in 2014. Given the unique sets of circumstances surrounding acquisitions, the Staff encourages registrants to either call the Staff or submit a written question to the Corporation Finance Office of the Chief Accountant in order to determine whether Rule 3-14 Financial Statements are required. If registrants decide to call the Staff directly, they may be asked to submit a formal question that includes all of the facts and circumstances in the fact pattern.

Recent Initial Public Offerings (IPOs)

Registrants that have recently completed REIT conversions and REITs that have recently completed IPOs are reminded that disclosures about property operating data, including disclosures about geographic information, square feet and/or other capacity measures in units, occupancy, rental rate and lease expirations for material property portfolios may continue to be useful information for investors in annual reports.

Registrants operating assets recently appearing in the public securities market (*e.g.*, single family housing) should consider what types of unique operating information would be useful to investors.

Dividends per Share

In previous years, the Staff has provided registrants with comments on whether or not dividends per share information should be included on the face of the annual income statement in accordance with ASC 260, despite the requirement to present dividends per share on the face of the interim income statements under Rule 10-01(b)(2) of Regulation S-X and the annual requirement to disclose dividends per share on the shareholders' equity statement under Rule 3-04 of Regulation S-X. Recognizing these conflicting pieces of literature, the Staff will no longer be commenting in this area.

Areas of Focus related to Equity REITs

MD&A

- Enhance analysis of factors underlying operating results (*e.g.*, reasons behind changes in occupancy or rental rates);
- Robust disclosure of management's known trends and uncertainties;
- Disclosure addressing the relative impact on period-to-period changes of same store portfolio and non-same store portfolio and, within same store portfolio, the relative impact of changes in occupancy and rental rates; and,
- When "same store" metrics are reported, disclosure of how the same store pool is defined (*i.e.*, the basis of including or excluding "stores").

Leasing Activity and Results

- Disclosure summarizing reporting period leasing activity for both new leases and lease renewals, including costs such as tenant improvements and leasing commissions, and quantitative disclosure of rental rate changes (*e.g.*, changes in rent spreads); and,
- When a significant amount of leasable space will expire over the next twelve months, disclosure of material known trends and uncertainties in current market rates on expiring space as compared to rents under current leases.

Areas of Focus related to Mortgage REITs

Fair Value Accounting

Registrants that report assets and/or liabilities at fair value are reminded to review the fair value hierarchy included in ASC 820 *Fair Value Measurements and Disclosures*. The classification of an asset or liability as Level 1, 2, or 3 drives the amount of required disclosures and could also impact loan covenants and/or risk management policies. For example, some loan covenants may limit the amount of financial assets classified as Level 3 within the fair value hierarchy.

Areas of Focus related to Spin-offs

While not directly related to the review of 2014 10-Ks, the Staff indicated a few areas of focus related to spin-offs.

The Staff reminds registrants to file the proper financial statements when executing a spin-off transaction. The following financial statements are typically required:

- Audited opening balance sheet;
- Carve-out financial statements for assets that have a rental history (not necessarily a legal structure prior to the spin-off) or audited schedule of investments for assets without a rental history;
- Rule 3-05 and/or Rule 3-14 financial statements as appropriate (the significance test should be calculated on the carve-out financial statement level, which is typically lower than the pre-spun-off basis);
- Significant tenant financial statements, especially in sale-leaseback transactions (if the spinor/future tenant was a public company, an explicit reference to periodic reports of that company may be sufficient);
- Pro forma financial statements: 1) Ensure that there is disclosure of the assets' basis (typically carryover basis); 2) Discuss the estimation process for significant income statement items; a) Registrants have the option to provide an unaudited financial forecast instead of a pro forma income statement in accordance with Rule 11-03 of Regulation S-X. The financial forecast should comply with the American Institute of Certified Public Accountants (AICPA) Standards for Forecasts and Projections.
- Schedule III disclosure: 1) Rule 12-28 of Regulation S-X requires supplemental information about real estate investments and accumulated depreciation; 2) Registrants may request relief from some of the specific disclosure, for example: a) A registrant may be unable to provide historical information on the initial cost of the real estate or the costs that were subsequently capitalized; or b) There may be a large number of insignificant assets – in this case, aggregation may be appropriate and acceptable.

Given the technical nature of spin-off transactions, registrants are encourages to pre-clear the accounting treatment with the Corporation Finance Office of the Chief Accountant.

CONTACT

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