Financial Standards Update

NAREIT's Report on Recent Financial Standards Developments

Highlights:

- NAREIT and its REESA Global Partners Oppose FASB and IASB Views on Lessor Accounting
- NAREIT/REESA Advocate the Use of Revenue Recognition Proposals as a Basis for Lessor Accounting
- FASB Excludes Partial Sales of In-Substance Real Estate from the Scope of SFAS 160
- NAREIT Focuses on SEC Questions around Reporting Operating Partnership Capital

NAREIT and its REESA Global Partners Oppose FASB and IASB Views on Lessor Accounting

In March 2009, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) (collectively, the Boards) released their preliminary views on revised standards for lease accounting by lessees. Rather than providing the Boards' views on specific standards for lessors, the Boards' proposal included a high-level discussion of lessor accounting issues. The Boards plan to issue future specific proposals on lessor accounting in the context of this project, or in connection with the Revenue Recognition Project (discussed below).

The most important preliminary conclusion of the Boards is that lease accounting should be based on a "right-of-use" model, which would require lessees to record assets on the balance sheet representing the rights to use leased assets and corresponding liabilities for the obligations to pay rents. For lessors, the Boards present two possible approaches in applying a "right-of-use" model that would significantly alter current lease accounting by real estate landlords.

The first approach would reflect the view that a lessor has transferred a portion of the rights to a leased asset to the lessee for the term of the lease. This approach would re-characterize a rental transaction for real property into a financing activity in the financial statements of real estate companies. Investment property would be re-characterized as two elements in the balance sheet: i) lease receivables; and, ii) the lessor's interest in the leased asset's residual value. In addition, a portion of the rental payments would be recognized as interest income on the lease receivable.

Alternatively, the second approach would continue to report the investment property on a real estate company's balance sheet and would add an asset representing a receivable for the right to receive lease payments and a liability that would represent the company's obligation to provide the leased space. This alternative would inflate a company's assets and liabilities. It would also present the same issue discussed above under the first approach in terms of reporting a portion of rental payments as interest income rather than the entire rental payment as rental revenue in the income statement.

On July 15, 2009, NAREIT and its partners of the Real Estate Equity Securitization Alliance (REESA) responded to the Boards on their preliminary views on revised lease accounting.

The REESA member organizations include:

- Asian Public Real Estate Association (APREA)
- Association for Real Estate Securitization (ARES)
- British Property Federation (BPF)
- European Public Real Estate Association (EPRA)
- National Association of Real Estate Investment Trusts (NAREIT)®
- Property Council of Australia (PCA)
- Real Property Association of Canada (REALpac)

In the letter, REESA strongly recommended that the accounting for investment property leases by lessors should be excluded from the proposal. REESA further explains that lessors should account for investment property leases as contracts for services under the general revenue recognition concepts proposed in the Revenue Discussion Paper and that such accounting should be incorporated within the scope of International Accounting Standard 40, *Investment Property* (IAS 40). All REESA members clearly believe that any of the Boards' proposed approaches to lessor accounting would not faithfully portray the economic substance of the investment property business. To read REESA's letter, CLICK HERE.

Additionally, NAREIT staff, along with other REESA representatives met with IASB and FASB staff and two Board members on July 14 to discuss the global industry's views on the lease accounting proposals. While REESA's views were generally received positively, REESA is in the process of arranging a follow-up meeting that will provide views of industry investors and other financial statement users on the Boards' proposals.

Further, NAREIT submitted a letter separate from REESA that reasserted REESA's global views, as well as provided the specific views of NAREIT members developed by a member task force. These specific views included concerns about the high level of uncertainty and variability that would be used in estimating the present value of the most likely lease payments over the most likely lease term discounted using the lessee's incremental borrowing rate, especially for leases that extend over long periods and involve variable outcomes. The letter also discussed the lack of guidance in such areas as accounting for reimbursable costs, tenant improvements, tenant allowances and co-tenancies. To read NAREIT's letter, CLICK HERE.

NAREIT's positions on any proposed changes to lessor accounting are guided by its previous comments in meetings with both the FASB and the Securities Exchange Commission (SEC) that NAREIT and its global partners would oppose any approach to lease accounting that would re-characterize, in financial statements, a $1 trillion global operating real estate industry to a financing business.

The Boards plan to issue an Exposure Draft in 2010 and a final standard for lease accounting in 2011. For an update on the status of the Lease Accounting Project, CLICK HERE.

NAREIT/REESA Advocate the Use of Revenue Recognition Proposals as a Basis for Lessor Accounting

In an effort to clarify revenue recognition principles and to create a converged revenue recognition standard between U.S. Generally Accepted Accounting Principles (GAAP) and

International Financial Reporting Standards (IFRS), the Boards issued a Discussion Paper, *Preliminary Views on Revenue Recognition in Contracts with Customers* (the Revenue Discussion Paper). The overarching principle contained in the proposed contract-based revenue recognition model is to recognize revenue when the seller/provider satisfies a "performance obligation" by transferring goods or services (or "rights to use space" for our industry) to a customer as contractually agreed.

When a company enters into a contract with a customer, the company obtains rights to payments from the customer and assumes obligations to provide goods or services to the customer, referred to as performance obligations in the Revenue Discussion Paper. The combination of those rights and obligations produces a net contract position that can be an asset, a liability or net zero position for the company. When performance obligations are satisfied, a company's net contract position increases and revenue is recognized.

In the Revenue Discussion Paper, the Boards propose that the amount of revenue recognized would be the consideration received from the customer in exchange for transferring goods and services under the contract. This amount would be based on an allocation of the customer's consideration. If a bundle of goods and services are transferred to a customer all at the same time, a company would recognize revenue in the contracted amount at the time of the transfer. On the other hand, if the company transfers goods and services at different times, it needs to allocate the total consideration to each performance obligation in proportion to the company's stand-alone selling price for the promised good or service.

International Accounting Standards Board ®

On June 19, 2009, REESA submitted a comment letter to the FASB and IASB in response to their preliminary views on revenue recognition. In the letter, REESA strongly asserts its view that lessors should account for investment property leases as service contracts under the general revenue recognition concepts in the Revenue Discussion Paper. REESA further explains that the contracted leased payments should be used to value the performance obligations so that rental revenue recognized would equal the contracted lease payments.

In the letter, REESA also conveys the important linkage between rental revenue and investment property fair value that should be maintained in the financial statements in order to accurately report the economics of investment property. REESA also addresses additional issues in its letter, such as how the continuing involvement principles for in substance real estate under Statement of Financial Accounting Standards 66, *Accounting for Sales of Real Estate* (SFAS 66)[1] and the concept of transfer of control related to construction contracts would apply under the proposal. To read REESA's comment letter, CLICK HERE.

[1] SFAS 66 is referenced as topic 976 under the FASB Accounting Standards Codification (the Codification). In this Financial Standards Update issue, NAREIT cites U.S. GAAP using the applicable references prior to the effective date of the Codification.

Although lessor accounting may be resolved in the Boards' Lease Accounting Project discussed above, it will probably be influenced by the conclusions reached in this project. The Boards expect to release the related Exposure Draft in 2010 with the issuance of a final standard planned for 2011. To learn more about the progress made on the Revenue Recognition Project, CLICK HERE.

FASB Releases Final Standard on Variable Interest Entities

After evaluating the comments on its 2008 proposal to amend *FASB Interpretation No. 46(R)* (FIN 46(R)), in June 2009 the FASB released Statement of Financial Accounting Standards 167, *Amendments to FASB Interpretation No. 46(R)* (SFAS 167). The standard modifies the accounting and reporting for a variable interest entity (VIE) and eliminates the exceptions previously applicable to the consolidation of qualified special purpose entities. This standard will most likely result in more securitization arrangements being reported on the balance sheets of sponsoring companies.

SFAS 167 is effective as of the beginning of the first annual reporting period that begins after November 15, 2009 and for the interim and annual reporting periods thereafter. Early application is prohibited. Companies are not required to restate previously issued financial statements, although the FASB does not preclude companies from such restatements.

As a result of the initial adoption of SFAS 167, companies will be required to initially measure the carrying amount of any consolidated VIE at the date that SFAS 167 first applies, with any necessary cumulative-effect adjustments recorded to retained earnings. Under SFAS 167, the carrying amount is defined as the amount at which the VIEs' assets, liabilities and noncontrolling interests would have been carried in the consolidated financial statements if SFAS 167 had been effective when the company first met the primary beneficiary guidelines.

SFAS 167 requires entities to perform a continuous qualitative analysis in determining whether an entity is the primary beneficiary, or has the control, of a VIE. The qualitative analysis identifies the primary beneficiary as the entity that has both: 1) the power to direct the activities of a VIE that most significantly impact the VIE's economic performance; and, 2) the obligation to absorb losses of the VIE or the right to receive benefits from the VIE.

While the Board considered NAREIT's recommendation in its 2008 letter to maintain the substantive kick-out rights criteria in the determination of consolidating VIEs (CLICK HERE to access NAREIT's letter), the Board reaffirmed its proposed views. Under SFAS 167, only unilateral substantive kick-out rights are considered in the determination of the entity that has the power to direct the activities of the VIE. This change may cause companies to consolidate VIEs if the VIEs were previously unconsolidated based on the substantive rights of the limited partners to remove the general partner.

Additionally, as a result of the Board's definition of a primary beneficiary, certain consolidated joint ventures that are VIEs may be forced to be deconsolidated under the new standard – a consequence addressed in NAREIT's comment letter. Since the power to direct the VIE's activities is equally shared in many joint ventures, none of the parties may have a unilateral controlling financial interest in the VIE. As a result, the VIE would not be consolidated by any of the investors.

Furthermore, the Board eliminated its original proposal that would have required investors to perform continuous reassessments in determining whether an entity is a VIE, which should provide some relief to preparers. Therefore, SFAS 167 retains the FIN 46(R) requirements for VIE reassessments that are based on the occurrence of certain triggering events. The new standard also adds a criterion for reassessing an entity's VIE status upon an event in which the holders of interests in the entity lose the ability through voting rights to make decisions that have a significant impact on the entity.

Although the FASB decided to drop the proposal for continuous VIE reassessments, it maintained its view to require continuous reassessments of whether an entity is the primary beneficiary of a VIE. However, the FASB permits these reassessments to be a qualitative analysis and more principles based, as opposed to the detailed calculations involved in the previously required quantitative assessments. The elimination of the quantitative analysis, which explicitly factors in expected losses and expected residual returns in the determination of the primary beneficiary, should be beneficial to preparers.

In accordance with SFAS 167, companies are required to provide additional disclosures such as the significant assumptions made in determining whether to consolidate a VIE and the nature of the risks associated with a company's involvement with a VIE. To read more on SFAS 167, CLICK HERE.

In regard to IFRS convergence, the FASB and IASB may potentially issue a future converged standard on the consolidation of all entities. The FASB currently has consolidations as an item on its research agenda.

FASB Excludes Partial Sales of In-Substance Real Estate from the Scope of SFAS 160

In 2008, constituents of the FASB acknowledged that two separate standards provide accounting guidance on the partial sales of interests in consolidated entities that represent "in-substance real estate" – entities whose assets comprise a substantial amount of real estate.

Late last year, the Emerging Issues Task Force (EITF) released for exposure Issue No. 08-10 (EITF 08-10), *Selected Statement 160 Implementation Questions*. EITF 08-10 specifically raises the issue of how an entity should account for the sale of a partial interest in a consolidated entity that is in-substance real estate. Statement of Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (SFAS 160) and SFAS 66 both provide guidance on the accounting for partial sales of interests in subsidiaries that could result in very different outcomes. These differences could include different timing for recognition of profit, different amounts of profit (or loss) on the partial sales and different carrying values for the retained interest. For example, SFAS 160 requires that, under certain conditions, the retained interest should be marked to fair value. However, SFAS 66 does not permit these fair value adjustments.

On June 24, 2009, the FASB decided to modify the scope of SFAS 160 to exclude partial sales of interests in consolidated entities that are in-substance real estate. As a result, the guidance in SFAS 66 prevails over SFAS 160 for such transactions. For more information on the FASB's decisions, CLICK HERE.

NAREIT Focuses on SEC Questions around Reporting Operating Partnership Capital

A number of NAREIT member companies are in the process of responding to comments received from the SEC staff on the financial statements of the operating partnership (OP) regarding the application of EITF D-98, *Classification and Measurement of Redeemable Securities* (EITF D-98). This EITF provides guidance as to whether redeemable OP capital should be reported outside of permanent equity. The primary concern of the SEC staff seems to be gaining an understanding of the basis of the company's conclusion with respect to the classification of OP capital under EITF D-98.

NAREIT staff has discussed this SEC question with a number of member companies, industry attorneys and representatives of accounting firms that are involved in responding to the SEC comments. At this time, NAREIT believes an important focus of the SEC staff is to understand the fiduciary relationship between the REIT and the OP, and whether there are potential conflicts of interest between the REIT and OP in terms of the decision to redeem OP units using cash or REIT shares. In comments to a number of REITs, the SEC staff has requested a legal analysis supporting a conclusion that no conflicts of interest exist that would preclude the REIT from providing shares to redeem OP units. NAREIT is considering how it can best provide support to the consideration of this issue.

NAREIT/REESA Develop Comments on IASB Income Tax Proposal

In another collaborative effort, NAREIT and its global REESA partners are preparing a comment letter in response to the IASB's Exposure Draft on Income Taxes (the IASB Tax ED), which includes proposals that would replace International Accounting Standard 12, *Income Taxes* (IAS 12).

In line with its convergence goals, the FASB expects to obtain input from U.S. constituents on the IASB's proposed replacement of IAS 12. Following the review of comments, the FASB will decide whether to undertake projects that would eliminate differences in the accounting for tax between U.S. GAAP and IFRS. The IASB provides a summary of the differences between the proposals and U.S. GAAP in its basis for conclusions. To read the IASB Tax ED, CLICK HERE.

The IASB Tax ED maintains the fundamental principles of IAS 12 in applying a temporary difference approach to determine deferred tax assets and liabilities. However, the IASB Tax ED proposes significant changes to current standards, such as:

1) applying the probability-weighted average of all possible outcomes to measure current and deferred tax assets and liabilities for uncertain

tax positions (current IAS 12 does not provide guidance on the treatment of such amounts);

2) adding criterion that requires the tax basis of an asset to be determined by the tax deductions that would be available if the entity recovered the carrying amount of the asset by sale; and,

3) requiring the initial measurement of assets and liabilities that have tax bases different from their initial carrying amounts.

REESA strongly disagrees with the IASB's proposal to include a weighted average of all possible outcomes to measure current and deferred taxes for uncertain tax positions and plans to share its views in its comment letter to the IASB.

FASB Launches New Accounting Standards Codification

On July 1, 2009, the FASB released the FASB Accounting Standards Codification (the Codification) under Statement of Financial Accounting Standards No. 168 (SFAS 168) – the final statement issued prior to the release of the Codification. The Codification represents the source of authoritative U.S. GAAP and will replace all existing non-SEC accounting and reporting standards. All other non-grandfathered, non-SEC accounting literature not included in the Codification will become non-authoritative.

All guidance contained in the Codification has the same level of authority. The Board will no longer issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. Subsequent to July 1, the FASB will issue Accounting Standards Updates that will update the Codification, offer additional background information and provide the bases for conclusions on the amendments to the Codification.

The rules and interpretive releases of the SEC remain sources of authoritative GAAP for SEC registrants. The release of the Codification is not intended to change current U.S. GAAP. SFAS 168 is effective for financial statements issued for interim and annual periods ending after September 15, 2009 and applies to all nongovernmental entities. Subsequent to the effective date, all references to authoritative U.S. GAAP should refer to sections in the Codification. To access SFAS 168, CLICK HERE.

2009 Financial Standards Events

Internal Audit Forum

The 2009 Internal Audit Forum will be held on Aug. 18 and 19 in San Francisco, CA. Attendance at this program is by invitation only. The event will be hosted by BRE Properties, Inc. and Boston Properties, Inc. The Internal Audit Forum is designed exclusively for internal audit directors or other senior level financial professionals responsible for a company's internal audit function. This annual event has proven to be successful in providing useful information in improving the internal audit function. This year's program will cover topics, such as enterprise risk management, data analytics, fraud and IFRS, and will include sector breakouts. Special guest speakers will be Constance Moore, President and CEO, BRE Properties, Inc. and NAREIT Chair, as well as Patricia Miller, Partner, Deloitte and former Chair of the Institute of Internal Auditors. For registration information for this event, please contact Sarah Anastas at sanastas@nareit.com or (202) 739-9433.

Financial Standards Update

NAREIT's Report on Recent Financial Standards Developments

Retail Sector Operations Accounting Forum

Based on input from the participants of last year's forum, NAREIT has decided to cancel the Retail Sector Operations Accounting Forum for 2009, in part due to the current condition of the economy. NAREIT and representatives from retail member companies will reconsider this event for 2010.

Senior Financial Officers/Investor Relations Officers Workshop

NAREIT's 2009 Senior Financial Officers/Investor Relations Officers Workshop will be held on September 21 and 22 in New York City. Attendance at this program is by invitation only. The workshop is specifically designed for senior officers in the fields of accounting, financial reporting, capital markets, insurance and investor relations. The workshop focuses on the latest developments and trends impacting the financial management of real estate companies. Program Directors are considering the following important timely topics:

- the current capital market and its impacts on deal structures, covenants, equity issuances, hybrid convertibles and preferred securities, hedging activities and investments abroad;
- analysts' views of industry reporting;
- the effects of the economic environment on operations and lease structures (*i.e.,* concessions, rent, abatement and CAM management);
- NAREIT/REESA advocacy with respect to global convergence projects on discontinued operations, financial statement presentation, revenue recognition and lease accounting; and,
- Financial Reporting Hot Topics (*i.e.,* SFAS 160, *Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51*; SFAS 157, *Fair Value Measurements*; and, EITF D-98, *Classification and Measurement of Redeemable Securities*).

Workshop registration materials have been distributed.

NAREIT
Steven A. Wechsler
President and CEO
(202) 739-9400 swechsler@nareit.com
Policy and Politics
Tony M. Edwards
Executive Vice President and General Counsel
(202) 739-9408 tedwards@nareit.com
Financial Standards Staff
George L. Yungmann
Senior Vice President, Financial Standards
(202) 739-9432 gyungmann@nareit.com
Sally Glenn
Director, Financial Standards
(202) 739-9442 sglenn@nareit.com