April 22, 2002

NAREIT Real Estate Accounting

Quarterly

National Association of Real Estate Investment Trusts®

Meeting Notice

WHAT: NAREIT Accounting Committee

WHERE: Law & Accounting Conference
The Broadmoor Hotel and Resort
Colorado Hall A/B
Colorado Springs, Colorado

WHEN: Wednesday, May 8, 2002
1:30-3:00 pm

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NAREIT Affirms Commitment to GAAP Net Income; Clarifies FFO Definition

On April 4, 2002, NAREIT's Board of Governors adopted findings and recommendations of the Best Financial Practices Council that affirm net income under generally accepted accounting principles (GAAP) as the industry's primary earnings measure and clarify the definition of Funds From Operations (FFO) so that relevant financial items from income-producing property held for sale, sold or otherwise transferred and reported in "results of discontinued operations" (as defined by GAAP) continue to be included in FFO.

This action follows the Financial Accounting Standards Board's (FASB) issuance and interpretation of Statement of Financial Accounting Standards No.144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, as it applies to property sales by real estate companies. Statement 144, which applies to all industries and took effect on January 1, 2002 for calendar-year companies, expands the definition of "discontinued operations" to include the disposition of a component (asset) of an entity that "comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of an entity."

The following summarizes the findings and recommendations made by the Best Financial Practices Council and adopted by the Board of Governors:

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- NAREIT recognizes and emphasizes that GAAP net income is the primary earnings measure for real estate companies.
- NAREIT welcomes the efforts of analysts and others to increasingly rely upon and utilize net income, as defined by GAAP, in analysis of the real estate industry and individual companies.
- NAREIT believes that FFO remains a useful supplemental earnings measure for a variety of reasons, including the treatment of depreciation and gains and losses on property sales under GAAP.
- NAREIT believes that, consistent with the intended purpose of FFO and past practice, items previously included in the calculation of FFO from income-producing properties, whether currently in use, held for sale, sold or otherwise transferred, should be presented as part of FFO for current periods as well as prior periods presented.
- NAREIT recommends that full disclosure be made of amounts reported in "results of discontinued operations." These disclosures should identify FFO, gains/losses and other items included in results of discontinued operations.

Under Statement 144, both the results of operations for all periods presented and the gains/losses from most property dispositions must be reclassified from continuing operations to discontinued operations. Prior to the clarification, NAREIT's White Paper on FFO provided guidance on the calculation of FFO to exclude Results of Discontinued Operations. Without the clarification, most transfers of property (even like-kind exchanges) would have resulted in revisions to previously reported FFO as well as to FFO for the year the property is transferred, even though there would be no change to bottom-line GAAP net income reported in current or previous periods presented. To mirror the impact of Statement 144 on GAAP net income, the Council recommended that NAREIT's Board clarify the FFO White Paper so that the benchmark would include FFO from both Continuing Operations and Discontinued Operations, resulting in no change to bottom-line FFO.

The clarification is effective January 1, 2002, and should be applied to all periods presented in financial statements or tables. As in the past, FFO excludes gain or loss on the sale of property (other than property such as securities and property classified as inventory).

In reaching its recommendation, the Council considered comments received from member companies, industry investors, analysts and other participants. The Council wishes to thank all of those who participated in this review of the industry's supplemental performance benchmark. In its report, the Council also reiterated that the primary purpose for reporting FFO is to provide a meaningful supplemental operating metric on which to base comparisons between companies and between reporting periods. This necessitated the current clarification in order for FFO to continue to represent a meaningful supplemental operating metric that is comparable across the industry.

NAREIT's FFO White Paper has been revised to reflect this clarification of the benchmark and to provide guidance in implementing this clarification. NAREIT also distributed a National Policy Bulletin on April 5, 2002 to provide further details about this clarification. The revised FFO White Paper and National Policy Bulletin are available on the web at www.nareit.com (click on "Accounting Issues" and "FFO White Paper").

EITF Project

As a result of the issuance of Statement 144, a number of questions have been raised regarding

the allocation of interest to "results of discontinued operations." In March 2002, the FASB's Emerging Issues Task Force (EITF) agreed to reconsider and update the guidance in EITF Issue No. 87-24, *Allocation of Interest to Discontinued Operations*. Issue 87-24 allows for, but does not require, the allocation of interest to discontinued operations and provides specific methodology. NAREIT will monitor this project and consider commenting on the issue.

Financial Reporting and Disclosure Reforms Proposed

The financial reporting events of last fall have led to the scrutiny of all participants and activities involved in the financial reporting process. Reform proposals are being brought forward for consideration by any number of stakeholders. The proposed reforms would influence the activities of managements of public companies, boards of directors, audit committees, auditors, analysts, attorneys, the Financial Accounting Standards Board (FASB) and other standard setters, credit rating agencies, and the Securities and Exchange Commission (SEC). In Congress, lawmakers are floating several pieces of proposed legislation. In addition, stock exchanges are considering rule changes that would mirror some of these proposals.

Influential industry groups also have weighed in with their recommendations on how the financial reporting system should be "fixed." Included among these groups are Financial Executives International (FEI), The Association for Investment Management and Research (AIMR) and the Council of Institutional Investors (CII). FEI in March 2002 set forth 12 observations and recommendations for improving financial management, financial reporting and corporate governance (http://www.fei.org/download/ReformRecommendations.pdf), while AIMR on February 15 stated its position in "advertisements" in both *The Wall Street Journal* and *The Washington Post* (http://www.aimr.org/pressroom/02releases/02adWSJ_Post.html), and CII on February 4 outlined suggested reforms for auditing and corporate governance systems (http://www.cii.org/press/pressrelease.htm).

SEC Proposes Changes for Periodic Filings, 8-Ks, Insider Transactions

Meanwhile, on April 11, 2002, the Securities and Exchange Commission (SEC) formally initiated its rulemaking effort aimed at "real time" reporting by issuing proposals to improve the financial reporting and disclosure system. One of the proposals would accelerate the filing of annual reports to 60 from 90 days, quarterly reports to 30 from 45 days, as well as reports of insider transactions. They also seek to add a requirement that public companies disclose whether they provide access to their annual, quarterly and current reports on Form 8-K on their websites at the same time they are filed with the SEC. Companies not providing web site access would have to provide reasons for not doing so.

Further, certain directors' and executive officers' transactions in company equity securities and loans of money to a director or executive officer made or guaranteed by the company collateralized by the director's or executive officer's company equity securities also would have to be reported on Form 8-K.

NAREIT plans to form a joint task force of its Accounting Committee and SEC Subcommittee to review the SEC proposals. If you are interested in participating, please contact David Taube at dtaube@nareit.com.

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Update on AICPA Activities

Review of Cost Capitalization Proposal Set; Update on Joint Ventures

On Wednesday, May 1, 2002, the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountant's (AICPA) will review its proposal that establishes standards for when costs associated with property, plant and equipment should be capitalized or expensed. The meeting will start at 8am at AICPA offices in New York (1211 Avenue of the Americas). This item was originally on AcSEC's agenda from 8am to Noon, but is now expected to extend into the afternoon.

An AcSEC Task Force has been revising the proposal based on approximately 400 comment letters received last fall. This is the first public meeting during which the proposal will be discussed since the close of the comment period. The comments received have resulted in a thorough review of the proposal.

NAREIT staff will attend the meeting. If you would like to attend, for security purposes you must provide the AICPA your name in advance and provide a picture ID to gain entrance to the building. At the AICPA, please contact Sharon Macey at smacey@aicpa.org or 212-596-6167.

With regard to the AcSEC's project to provide new guidance on accounting for joint ventures, a revised prospectus is being finalized that would broaden the proposal to apply to all equity method investments not covered by Accounting Principles Board No. 18, *Investments in Common Stock*. Once AcSEC's planning subcommittee approves the prospectus (expected in the second quarter of 2002), it will be presented to the FASB for clearance as a project.

Proposal on Fraud Detection

In February 2002, the AICPA's Auditing Standards Board (ASB) issued proposed guidance to help auditors detect material misstatements due to their clients' fraud. The proposed Statement on Auditing Standards (SAS), titled *Consideration of Fraud in a Financial Statement Audit*, would supersede a Statement by the same name, SAS 82. The proposal would not change an auditor's responsibility to plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, but would establish standards and provide guidance in fulfilling that responsibility as it relates to fraud.

With research indicating that the recording of false entries through management override of controls being a major source of fraud, the new standard would mandate that auditors search for fictitious entries and perform other tests to assess risk of management override. The tests would be required to be performed on every public company audit. Another area of concern is revenue manipulation. Accordingly, the new standard would provide additional guidance on how to test for improper revenue recognition.

Related to the issue of fraud detection, in 2002 the ASB also is planning to issue fraud deterrence guidelines and recommendations that would be directed toward audit committees and management.

The new SAS would be effective for audits of periods beginning on or after December 15, 2002. The comment letter deadline is May 31, 2002. The proposal is available on the web at: http://ftp.aicpa.org/public/download/members/div/auditstd/finalEDSASConsiderationofFraud.pdf.

Update on FASB Activities

Accounting for Debt Extinguishments

On February 7, 2002, the Financial Accounting Standards Board (FASB) affirmed its decision to rescind FASB Statement No. 4,

Reporting Gains and Losses from Extinguishment of Debt. The rescission of Statement 4 eliminates the **requirement** that all gains and losses from the extinguishment of debt be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. However, a company could continue to classify transactions as extraordinary items if they are both unusual in nature and infrequent in occurrence.

On December 13, 2001, NAREIT distributed a National Accounting Alert based on the FASB's November 2001 Exposure Draft that proposed the rescission of Statement 4. In response to the proposal, NAREIT submitted a comment letter indicating its support, but suggesting that the effective date and transition requirements be revised from retroactive to prospective application, beginning in the fiscal year after the issuance of a final standard. NAREIT's comment letter and National Accounting Alert are available in the Accounting Issues section of www.nareit.com.

The proposal is being revised to provide an effective date of fiscal years beginning after its issuance (expected in May 2002), resulting in a year-2003 effective date for calendar-year companies. This revised transition provision is consistent with NAREIT's request in its industry comment letter. As part of the transition guidance, gains and losses from debt extinguishments in prior periods presented in financial statements must be reclassified (to continuing operations) if they do not meet the criteria in APB 30.

Because real estate companies frequently and routinely extinguish debt, this proposal would, in most cases, eliminate the ability to report these transactions as extraordinary items unless they meet the criteria in APB 30. Since the gains and losses from debt extinguishments would be included in continuing operations under GAAP, they would be included in the calculation of FFO under the current interpretation.

Focus on Special-Purpose Entities and Guarantees

In the aftermath of last year's financial reporting events, the FASB has been focusing its efforts on fast-track accounting proposals that would provide interpretive guidance on Accounting Research Bulletin No. 51, *Consolidated Financial Statements,* and Statement of Financial Accounting Standards No. 94, *Consolidation of All Majority-Owned Subsidiaries*.

One project would further restrict the circumstances under which a company would not be required to consolidate special-purpose entities (SPE). This includes increasing the "independent equity at risk" threshold to qualify as an SPE from three percent to 10 percent and requiring consolidation if the company guarantees or provides other arrangements that shield outside investors from losses of the SPE.

The proposal to increase the "independent equity at risk" threshold could benefit real estate companies by limiting or halting the use of synthetic leases, leading corporate real estate owners to seek other ways of moving their real estate assets and related liabilities off-balance sheet. The changes could result in real estate companies having increased transaction activity with corporate real estate owners, notably in the triple-net lease and sale-leaseback arenas.

The interpretation also may provide guidance on accounting issues related to collateralized debt obligations (CDO). Because of the potential for negative impacts on CMBS transitions, The Real Estate Roundtable (RER) is very active in monitoring this project as it relates to securitized debt and mortgage obligations. Please see their

web site (www.rer.org) for further information.

In a separate, but related project on guarantees, the FASB is concerned with arrangements when a guarantor issues a guarantee of debt or other forms of guarantees. This project is expected to result in an interpretation of Statement 94 that would provide guidance on disclosures, recognition and measurement of guarantees contained in certain types of contracts.

The FASB plans to issue proposals with a 30-day comment period in the second quarter of 2002. Final guidance for both projects is expected by the end of the summer or early fall. For SPEs existing at the time the interpretation is issued, the guidance would be applicable to calendar-year companies beginning January 1, 2003. For SPEs created after issuance of the guidance, the effective date could be as early as August 1. For the guarantees project, the FASB concluded that the disclosure requirements should be effective for financial statements for interim or annual periods ending after September 30, 2002.

Project on Purchase Method Procedures

Following the issuance of SFAS No. 141, *Business Combinations*, the FASB has initiated a project that would provide guidance on purchase method accounting procedures. A set of proposed rules is expected to be issued in the fourth quarter of 2002, with final rules planned for 2003.

An area that is being reviewed is the accounting for contingencies assumed in or connected with a business combination. The FASB has reached tentative decisions regarding contingent assets and liabilities, as well as contingent consideration, that provides for a fair value framework. Contingent assets and liabilities that are financial instruments would be accounted for in accordance with accounting guidance appicable to financial instruments. Contingent liabilities that are not financial instruments would be accounted for on a fair value basis, while contingent assets that are not financial instruments would meet the definition of an intangible asset and be accounted for under SFAS No. 142, *Goodwill and Other Intangible Assets*.

With regard to contingent consideration, the FASB has concluded that it is an obligation of the acquirer as of the acquisition date, and should be measured at fair value and recognized as part of the purchase price as of that date. Contingent consideration arrangements that are derivatives would be accounted for under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Subsequent remeasurement of obligations classified as either liabilities or equity would not result in a change to the purchase price of the business combination. The change in value would be recorded in the income statement.

The proposed accounting for contingent consideration represents a marked change from current practice. Under current rules outlined in Statement 141, which mirror the guidance in Accounting Principles Board No. 16, *Business Combinations*, the existence of a contingency should be disclosed but not recorded "unless the outcome of the contingency is determinable beyond a reasonable doubt."

NAREIT will continue to monitor this project and consider the formation of a task force upon issuance of a proposal.

Other Standards Development

In March 2002, the FASB's Emerging Issues Task Force (EITF) considered the definition of common control as it relates to a business combination. In Issue 02-5, *Definition of "Common Control" in Relation to FASB Statement No. 141, Business Combinations*, the EITF would determine whether to provide guidance on the meaning of the term "common

control" as used in Statement 141. Under Statement 141, the term "business combination" excludes transfers of net assets or exchanges of equity interests between entities under common control. In these situations, related asssets and liabilties are recorded at their carrying amounts at the date of transfer. However, Statement 141 does not define the term "common control."

In a 1997 speech to the AICPA National Conference on Current SEC Developments, the SEC staff provided its views on common control. In part, their guidance indicated that (1) common control between different companies often exists when one shareholder holds more than 50% of the voting ownership of each company, and (2) may also exist when a group of shareholders holds more than 50% of the voting ownership of each company, and all members of the group agree to vote those shares in concert.

The SEC staff has taken the position that, in order for different companies owned by individuals that are not members of an immediate family to be considered under common control, there must be "contemporaneous written evidence of an agreement to vote a majority of an entity's shares in concert."

The SEC has undertaken an initiative to remove staff speeches from its web site. At the same time, the FASB is expected to provide guidance on the meaning of common control in connection with phase two of its business combinations project dealing with new basis issues. However, no time frame for this project has been established. As a result of these developments, the EITF is considering whether to provide interim guidance that would determine whether separate entities are under common control, in the context of Statement 141, when common majority ownership exists by an individual, a family, or a group affiliated in some manner. The EITF plans further discussion of the topic at a future meeting.

NAREIT 2002 Law & Accounting Conference

Final arrangements are being made for NAREIT's 2002 Law & Accounting Conference to be held May 8-10 at The Broadmoor Hotel and Resort, Colorado Springs, Colorado. The Conference is the best way for real estate executives and others to keep abreast of financial reporting, legal, and tax developments affecting the industry. In addition to the items to be discussed at the Accounting Committee meeting, some of the notable topics to be presented include disclosures with respect to off-balance sheet activities (joint ventures), like kind exchanges, insurance issues, bankruptcy, process re-engineering, corporate governance and risk management. Registration materials were recently distributed. If you have any questions, please contact Barbara Drag at (202) 739-9400 or bdrag@nareit.com, or you can register online at www.nareit.com.

Any questions about industry accounting and financial reporting practices should be directed to George Yungmann, Vice President, Financial Standards, at (202) 739-9432, gyungmann@nareit.com, or David Taube, Director, Financial Standards, at (202) 739-9442, dtaube@nareit.com.