Real Estate Accounting Quarterly

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From the Council - FFO Guidelines

In its effort to enhance the quality, effectiveness and consistency 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. Issues related to the calculation and reporting of Funds From Operations (FFO) have been forwarded to the Council by NAREIT members. The following guidelines represent conclusions reached by the Council on these issues.

Impairment Losses

A number of corporate members have inquired about the appropriateness of adding to net income when calculating FFO, impairment losses/write-downs related to depreciable property. The Council concluded that impairment write-downs associated with previously depreciated operating property should be added back to GAAP net income to arrive at FFO whether the property is held for sale or is held/operated as a long-term investment.

Taxes

Members also have inquired as to whether taxes associated with asset dispositions should be included or excluded from FFO. The Council concluded that any taxes, current or deferred, directly associated with a gain or loss on a disposition of a property not included in FFO also should not be included in FFO. All other taxes, current or deferred, should be included in the calculation of FFO (i.e., not added back to net income in the calculation of FFO).

AcSEC Deliberates Initial Draft of Cost Cap SOP

In June 2000, the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) deliberated an initial draft Statement of Position (SOP), *Capitalization of Certain Costs Related to Property, Plant and Equipment*, that will specify which expenditures should be capitalized and which should be expensed. This project includes the capitalization accounting practices for property, plant and equipment (PP&E) for all industries, as well as the accounting for costs related to major repairs and maintenance expenditures (also known as overhauls and turnaround costs).

Of particular importance to the real estate industry was a lengthy discussion of which capitalization model contained in current accounting literature should be used by the AcSEC Task Force as a guide for development of the SOP. The two models discussed were the "full capitalization model," generally contained in Statement of Financial Accounting Standards (SFAS) No. 34, *Accounting for Interest Costs* and SFAS No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, and the "limited costing model" as reflected in SFAS No. 91, *Accounting for Non-refundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* and SOP 98-1, *Accounting for Costs of Computer Software Developed or Obtained for Internal Use*. Standards established more recently reflect the "limited costing model."

By a wide margin, the AcSEC tentatively voted to base conclusions in the proposed SOP on the limited cost model. Although the SOP project initially focused on costs not within the scope of SFAS 67 (i.e., those costs not related to real estate developed for rental or sale), at the June meeting the Financial Accounting Standards Board's (FASB) staff observer indicated that the FASB is open to the possibility of amending SFAS 67 to reflect the more recent trend in accounting philosophy. This conclusion probably would result in costs (particularly overhead and indirect costs) that are capitalized under current standards being expensed as incurred. Such an amendment could have a material negative impact on the net income and FFO of companies that develop investment property with internal staff. It was the preliminary consensus of the AcSEC that the limited costing model would apply to both the preacquisition and construction stages.

During its deliberations, the AcSEC reached tentative decisions on the following items:

- Project-stage framework - The AcSEC agreed that the SOP should provide guidance in a "project stage" framework including four stages: (1) Preliminary (prior to acquisition of specific PP&E being probable); (2) Preacquisition (subsequent to probable acquisition but prior to acquisition or construction); (3) Acquisition/ Construction; and (4) Operations (when PP&E is substantially complete and ready for its intended use).
- Option payments - It was the consensus of the AcSEC that all costs during the preliminary stage should be expensed. Option payments on land that probably will be acquired should be capitalized. If the option expires unexercised, or if it becomes no longer probable that the option will be exercised, any previously capitalized cost of the option should be charged to expense, net of probable recoveries from the sale of the option. The issue was raised (without conclusion) as to how to account for options on several parcels in a single, targeted development area.
- Real Estate Taxes, Insurance and Ground Rents - The AcSEC discussed the extent to which real estate taxes, insurance and ground rents should be capitalized. By a vote of 7 to 6, the AcSEC agreed that these costs could be capitalized during the development period - as it is defined in SFAS 34 covering interest capitalization.
- Demolition costs - The AcSEC agreed that costs of demolishing an existing structure concurrent with the acquisition of land could be capitalized as a cost of the land. However, the AcSEC voted 12 to 1 to not allow capitalization of demolition costs incurred on land already held by an entity, even when demolished in conjunction with planned construction of new PP&E on the land.
- Capitalization Criteria - By a vote of 9 to 4, the AcSEC agreed that costs that extend the originally expected useful life of PP&E should be capitalized. This assumes that normal, ongoing maintenance has been undertaken.
- Replacement Costs - The AcSEC discussed which costs of replacing a component of PP&E should be capitalized. Possibilities include:
  - Cost of removing an old component
  - Cost of a new component
  - Cost of installing a new component

  The AcSEC agreed by a vote of 12 to 1 that the costs of removing an old component should be expensed as incurred and that only the other costs should be capitalizable. Questions were raised as to the practicality of this position, but it stood as approved.
- Overhauls - AcSEC agreed (9-4) that planned major maintenance activities such as "overhauls" should be capitalized only to the extent that the costs are for the replacement of specific PP&E items.

The AcSEC plans to issue an exposure draft of the SOP in the fourth quarter of 2000, with a final standard effective for 2002. NAREIT's Cost Capitalization Task Force will continue to monitor the development of the SOP and submit comments to the AcSEC

Task Force as issues arise. AcSEC's next meeting to discuss the project is scheduled for Tuesday, July 25, 2000, in Seattle, Washington.

SEC Rulemaking

Bulletin on Contingent Rents Again Deferred

In December 1999, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*, clarifying generally accepted accounting principles (GAAP) related to accounting for contingent rental revenues. As it relates to real estate companies, SAB 101 specifies that contingent rental income should be recognized as revenue only when the specific target that triggers the contingent income is achieved. NAREIT's National Policy Bulletin on SAB 101 can be found under Accounting Issues in the Members Only section of www.nareit.com.

On June 26, 2000, the SEC issued SAB No. 101B, again deferring SAB 101. The amendment permits registrants to defer implementation of SAB 101 until no later than the fourth fiscal quarter of fiscal years beginning after December 15, 1999. For example, companies with a December 31 year-end may defer implementation of SAB 101 from the first quarter to the fourth quarter of 2000. Based on current GAAP, quarterly results for prior quarters in 2000 would be restated. As discussed in the last Real Estate Accounting Quarterly, in March 2000 the SEC had issued SAB 101A, permitting deferral of SAB 101 for registrants with fiscal years that begin between December 16, 1999 and March 15, 2000, from the first quarter to the second quarter of such fiscal year. The SEC staff determined that an additional delay would be appropriate to provide registrants with more time to assess the impact of the SAB on their financial statements.

As a reminder, the clarified definition of Funds From Operations (FFO) adopted by NAREIT in October 1999 (effective for all periods beginning on or after January 1, 2000) requires that FFO be calculated based on GAAP, including accounting for contingent rents in accordance with SABs 101 and 101B. However, any "cumulative effect" resulting from this change in accounting should not be included in FFO. The full text of SAB 101B can be found at http://www.sec.gov/rules/acctreps/sab101b1.htm.

NAREIT Comments on Selective Disclosure Proposal

In May 2000, NAREIT's Government Relations Committee submitted an industry comment letter in response to the SEC proposed rules, Regulation FD (Fair Disclosure), which would address 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, leaving 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 would have to promptly publicly disclose 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 seeks to clarify insider-trading issues.

NAREIT's submission advocated a narrower definition of "person acting on behalf of an issuer" in proposed Regulation FD. As proposed, Rule 101(c) would define "a person acting on behalf of an issuer" as "any officer, director, employee or agent of the issuer who discloses material nonpublic information while acting within the scope of his or her authority…." NAREIT suggested narrowing the definition to include only "any officer, director, employee or agent of the issuer who discloses material nonpublic information while acting within the scope of his or her authority *as the issuer's spokesperson….*" As an alternative, NAREIT suggested harmonizing the definition with proposed 101(d)(2); that is, to limit it to "any director, any executive officer, any investor relations or public relations officer, or any other person with similar functions."

NAREIT also strongly urged the Commission to exempt disclosures made under proposed Regulation FD from operation of Section 5(c) of the Securities Act of 1933. Section 5(c) of the Securities Act seeks to avoid "gun-jumping," or conditioning of the markets for an offering by prohibiting offers for securities until a registration statement has been filed. Penalties for violating Section 5(c) are significant in order to dissuade companies from "hyping" a prospective offering. Even if companies take all precautions to avoid violating Section 5(c), however, compliance with proposed Regulation FD as proposed could potentially cause REITs and other public companies to violate Section 5(c).

NAREIT also recommended that "listen-only" teleconference access and web site posting fulfill the "public disclosure" requirements of the release. The comment letter can be found under Government Relations in the Members Only section of www.nareit.com. Although selective disclosure is an SEC priority, no timetable has been set for issuance of final rules.

New Rules Proposed on Auditors' Independence

Concerned that accounting firms may not be able to provide truly independent audits to clients who are paying them for a multitude of other services, on June 30 the SEC issued proposed rules, *Revision of the Commission's Auditor Independence Requirements*, that would significantly limit the scope of services accounting firms can offer clients they audit. The proposal would update Rule 2-01 of Regulation S-X by prohibiting accountants from having a mutual or conflicting interest with the audit client, auditing their own work, functioning as management or employee of the audit client, or acting as an advocate of the audit client.

Some of the services that would be considered inconsistent with the notion of independence include the design and installation of hardware and software systems, bookkeeping, actuarial services, designing or operating internal controls, recruitment services, and investment and legal advice. Under the proposal, companies would be required to disclose in their annual proxy statements information about non-audit services provided by their auditors.

The SEC also is seeking comment on alternative auditor independence approaches:

- audit clients' audit committees could hire the auditor for non-audit services;
- a "firewall" approach in which an accounting firm creates subsidiaries for its various practices; and
- an approach that would permit auditors to disclose potential conflicts.

Some major accounting firms believe that there is little evidence suggesting that the marketing of consulting or other services has led to audit failures. In fact, they contend that the experience derived from these activities brings "increased sophistication to their audit practices."

The proposal also includes a provision that would loosen restrictions on what auditors and their families can invest in audit clients. The ban would be limited to those individuals personally involved in the audit. Employment relationships between auditors or their family members and audit clients also would be relaxed.

Although SEC Commissioners voted 4 to 0 to issue the proposal, one of the commissioners expressed concern that the 75-day comment period (following publication in the *Federal Register*) is not sufficient. This position has been echoed by the AICPA, which is seeking an extension of the period to 120 days. Public hearings will be held in July and September (see http://www.sec.gov/rules/extra/33-7872.htm for further information). The proposed rule can be viewed at http://www.sec.gov/rules/proposed/34-42994.htm.

Update on Accounting for Derivatives and Hedging

FASB Amendment Responds to NAREIT Concerns

In June 2000, the FASB issued SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities an amendment of FASB Statement No. 133*. The Statement addresses a limited number of issues causing implementation concerns governing the accounting and reporting for derivatives and hedging activities.

The amendment responds to concerns NAREIT's Derivatives and Hedging Task Force raised with the FASB by allowing a company to designate as the hedged risk the risk of changes in a benchmark interest rate, either LIBOR or US Treasury rates. For floating to fixed interest rate swaps, Treasury-locks, options, and other "cash-flow hedges" as defined by SFAS No. 133, changes in cash flows that occur from changes in the benchmark interest rate must be designated as the hedged risk and must be based on the same index. For example, real estate companies must use a LIBOR-based swap on a LIBOR based debt. In this example, by designating the LIBOR rate as the hedged risk, real estate companies are more likely to obtain hedge effectiveness.

Prior to this amendment, the hedged risk was the full interest rate - the benchmark rate plus the spread. If spreads changed more than nominally, the hedge was in jeopardy of becoming ineffective. If this occurred, the company would be required to mark the hedge to market at the end of each quarter and report the resulting gains/losses in net income. Under the amendment, the spreads are not considered part of the hedged risk, considerably reducing the probability of the hedge becoming ineffective. Further, the amendment requires companies to designate changes in either the US Treasury rate or LIBOR as the risk that is being hedged.

Also relevant to real estate companies is a modification on the rules for discontinued hedges related to forecasted transactions. The FASB's amendment provides for *an additional two-month period of time* beyond the originally specified time period for the forecasted transaction to occur before any net derivative gain or loss related to a discontinued hedge must be reported in earnings. Based on this clarification, real estate companies will need to forecast anticipated closings of originations or refinancings that are hedged using derivative instruments (e.g., Treasury Locks and Forward-starting swaps) within a precise time frame. Should companies not close the forecasted transaction within sixty days of the originally specified closing date, the unrealized gains and losses of any hedge used to lock in interest rates would be recognized in earnings.

SFAS 138 is available from the FASB Order Department at (800) 748-0659.

Companies Begin Implementation

SFAS 133/138 are effective for all fiscal quarters of fiscal years beginning after June 15, 2000. The new accounting is capturing the attention of calendar-year reporting real estate companies as they implement board and senior management sanctioned interest rate risk management policies and documentation before the standard takes effect on January 1, 2001.

Under the new standard, companies are required to adopt a policy statement that outlines its objectives and strategies for using derivative instruments and designate its derivatives as either a hedge of changes in fair value, cash flow or foreign currency based on the item being hedged. The policy statement will force companies to adopt certain internal controls and lead to a certain level of hedge effectiveness by increasing a user's understanding of the derivative instruments utilized.

The new accounting will enhance the transparency of hedging activities by requiring all derivative instruments to be reported as assets or liabilities at fair value in financial statements. All companies that hedge interest rate risk will be required to mark-to-market all hedges and report market value changes either in "other comprehensive income" or earnings. This distinction will be based on whether the hedge meets certain qualifying criteria, as well as the degree of effectiveness/ineffectiveness that occurs between the hedging instrument and the hedged item.

In addition to disclosing the financial effects of utilizing derivatives, for each reporting period, companies will be required to disclose each type of derivative instrument employed (fair value, cash flow, foreign currency, etc.), its risk management policy for each type of hedge, and a description of the items or transactions for which the risks are hedged. Disclosures are also required for derivatives not designated as hedging instruments. The FASB encourages companies to make qualitative disclosures about objectives and strategies for using derivatives in the context of their overall risk management profile.

FASB Activities

Purchase vs. Pooling Quagmire

With analysts and academics in one corner, the technology industry, venture capitalists, bankers and manufacturers in another, and the accounting firms somewhere in between, the FASB's September 1999 proposal to eliminate the pooling-of-interests method of accounting for business combinations has been the subject of two congressional hearings (one each for the House and Senate), a Senate roundtable discussion, FASB public hearings, as well as nearly 200 comment letters. For its part, convinced that its elimination will derail the "new economy," the technology industry has formed a group called the NETT Coalition (for 'New Economy Two Thousand') to hold hearings all over the country and lobby Capitol Hill.

Meanwhile, lawmakers on Capitol Hill have requested the SEC's chief economist to prepare an economic analysis of the implications of eliminating the pooling method and that the FASB prepare a study on accounting for intangible assets. In April, the FASB voted to not widen the scope of the project to consider all intangibles, including those internally generated. The business combinations project is concerned with all purchased intangibles, not those internally generated. The FASB has indicated it will not redeliberate whether to retain the pooling method until it has reached a comprehensive set of tentative decisions on the related subject of accounting for goodwill. Originally proposed to be effective on a prospective basis on January 1, 2001, in light of the attention and scrutiny the issue has garnered, at this juncture the FASB expects to issue final rules in the first quarter of 2001.

Consolidations Project

The FASB's consolidations project, which would require a parent company to consolidate all entities that it controls, appears to be headed for further delay as the Board considers whether to issue for comment a proposal on how to deal with "special-purpose entities" (SPEs) in the consolidations context. The FASB has been deliberating various issues related to SPEs to develop criteria for when they should be consolidated. The matter has proven difficult because SPEs are frequently structured to avoid consolidation.

Exposure Draft on Impairments Issued

On July 12, the FASB issued an exposure draft (ED), *Accounting for the Impairment or Disposal of Long-Lived Assets and for Obligations Associated with Disposal Activities*, that would supersede Statement 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, issued in March 1995.

The proposed Statement, which would retain the recognition and measurement provisions of Statement 121 for long-lived assets to be held and used, would provide additional guidance for implementing those provisions and establish a single accounting model for long-lived assets to be disposed. This accounting model also would apply to certain obligations associated with a disposal activity, including the restructuring of an existing activity, whether or not it involves the disposal of long-lived assets.

The proposal also would supersede the accounting and reporting provisions of Accounting Principles Board (APB) Opinion No. 30 that address the disposal of a segment of a business, so that the provisions of Statement 121, as proposed in the ED, would apply to discontinued segments. Reporting of discontinued operations would be extended to all "significant components" of an entity, thereby eliminating the definition of a segment of a business in APB 30.

The proposal defines impairment as the condition that exists when the carrying amount of an asset to be held and used exceeds its fair value, but, for practical reasons, it would not require that an impairment loss be recognized unless the carrying amount of the asset is not recoverable. The carrying amount of an asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset, excluding interest charges.

The proposal would be effective for quarterly financial statements issued for fiscal years beginning after December 15, 2001. The comment letter deadline is October 13, 2000. NAREIT is forming a task force to develop an industry comment letter. The ED is available on the Internet at: http://www.rutgers.edu/Accounting/raw/fasb/new/index.html. Anyone interested in participating should contact David Taube at dtaube@nariet.com.

Other Standards Developments

In May, the FASB's Emerging Issues Task Force (EITF) reached a decision on Issue No. 00-1, *Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Ventures.* The EITF concluded that pro-rata or proportionate financial statement presentation is not appropriate for an investment in an unincorporated legal entity accounted for by the equity method unless the investee is in either the construction industry or an extractive industry (e.g., mineral resources such as oil and gas exploration and production) where there is a longstanding practice of its use.

In Issue 00-13, the task force reached a consensus that equipment is considered integral equipment, subject to FASB Statements No. 66, *Accounting for Sales of Real Estate,* and No. 98, *Accounting for Leases*, when the combined total of both the cost to remove the equipment from its existing location and the decrease in the value of the equipment as a result of the removal exceeds ten percent of the fair value of the equipment installed. The cost to remove the equipment from its existing location includes the cost of repairing any damage to the existing location and, at a minimum, the decrease in value of the equipment as a result of its removal is the estimated cost to ship and reinstall the equipment at a new site. For leasing transactions, the information used to estimate those costs and decrease in value should be as of lease inception.

Determining whether equipment constitutes integral equipment has taken on increased importance with the issuance in 1999 of Interpretation No. 43, which concludes that sales of integral equipment are within the scope of FASB 66. The decision provides guidance for interpreting the phrase "cannot be removed and used separately without incurring significant cost" to eliminate diversity in practice as it relates to determining what is integral equipment.

NAREIT Forms Leases Task Force

In connection with its membership on the G4+1 group of accounting standards boards, the FASB recently issued a Special Report titled *Leases: Implementation of a New Approach.* With an objective to achieve convergence of financial reporting standards across countries so that the information is more useful to cross-border capital market participants, the Special Report contains a Position Paper developed by the G4+1 group that includes a general consensus on an approach to the recognition and measurement of rights and obligations that arise for lessees and lessors under lease contracts.

The Position Paper recommends that all leases should be reflected in financial statements in a consistent manner and it explores the principles that should determine the extent of the assets and liabilities that lessees and lessors would recognize under leases. The proposed lease accounting represents a significant change to the current "all-or-nothing" treatment of leases in the U.S. and elsewhere by contemplating its replacement with an approach that would require both lessees and lessors to record lease assets and liabilities on the balance sheet. This treatment would eliminate the accounting distinction between operating and capital leases with an approach that can be applied to all leases.

Under the recommended approach, the lessees of land and buildings would recognize at the beginning of a lease an asset and a liability equivalent to the fair value of the rights and obligations that are conveyed by the lease (usually the present value of the minimum payments required by the lease); thereafter, the accounting for the lease asset and liability would follow the normal requirements for accounting for fixed assets and debt. Lessors of land and buildings would report financial assets (representing amounts receivable from the lessee) and residual interests as separate assets. Amounts reported as financial assets by the lessors should, in general, be the converse of the amounts reported by lessees as liabilities.

The Position Paper also examines the principles for accounting for more complex features of lease contracts, including renewal options, contingent rentals, residual value guarantees and sale/leaseback transactions.

Although lease accounting is not on the FASB's agenda, the Special Report on Leases will provide information to the FASB for use in examining the effectiveness of existing standards and allow NAREIT to forward industry views. Further, with the FASB's and SEC's interest generally in harmonizing international accounting standards, the G4+1 effort could lead to a FASB project on lease accounting. NAREIT has organized a task force to prepare an industry comment letter in response to the Special Report. Anyone interested in joining this task force should contact David Taube at dtaube@nareit.com.

NAREIT 2000 SFO Workshop

The Senior Financial Officers (SFO) Workshop (formerly the CFO Workshop) is scheduled for Chicago, Illinois at the Westin O'Hare on November 13 and 14. The program begins on the evening of November 13th with a reception and dinner discussion. The following day will include a full program featuring sessions on capital markets, accounting, finance and other management issues designed exclusively for corporate member financial executives, such as CFOs, Controllers, Treasurers, Vice Presidents of Finance and Chief Accounting Officers. Look for program information in the mail in August.