NAREIT

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Meeting Notice

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What: NAREIT Accounting Committee
Where: NAREIT Annual Convention
Sheraton Chicago Hotel & Towers
Chicago Ballroom 9 & 10
Chicago, Illinois
When: Wednesday, October 10, 2001, 1:30-3:00 pm

NAREIT Activities

NAREIT Hosts Briefing on Cost Capitalization Proposal; Distributes Comment Letters

On September 10, 2001, NAREIT hosted a briefing on the American Institute of Certified Public Accountant's (AICPA) proposal that would establish uniform criteria for when costs associated with property, plant and equipment (PP&E) should be capitalized and expensed. Approximately 20 participants representing a wide range of industry trade groups and companies attended the briefing. In addition to real estate organizations such as The Real Estate Roundtable, the National Council of Real Estate Investment Fiduciaries and the National Association of Realtors, participants included representatives from electric and gas utilities, railroads, airlines, and manufacturers. NAREIT is encouraged by the extent to which participants have begun to prepare comments in response to the proposal.

The AICPA's proposed Statement of Position (SOP), *Accounting for Certain Costs and Activities Related to Property, Plant and Equipment*, includes capitalization accounting guidance for PP&E for all industries, while a companion proposal from the Financial Accounting Standards Board (FASB) would amend Statement of Financial Accounting Standards (SFAS) No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to exclude from the scope of SFAS 67 the accounting for the capitalization of costs and initial lease up related to real estate projects acquired or developed <u>for rental</u>.

The proposals would dramatically change the way companies are required to account for PP&E by:

- Increasing administrative expenses by requiring detailed component accounting.
- Increasing depreciation expense volatility by requiring a charge for the remaining net book value of a replaced PP&E or a component.
- Virtually eliminating the composite/group methods of depreciation.
- Virtually eliminating deferred cost accounting associated with PP&E.
- Increasing expenses by requiring the expensing of certain indirect and overhead costs currently permitted to be capitalized.

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Comment Letters Distributed; Deadline Extended

Significant changes to the proposals will require comments from a broad spectrum of industry groups and their member companies. To assist NAREIT member companies develop responses to the proposal, on September 26 NAREIT distributed to its Accounting Committee "final drafts" of its comment letters along with a memo highlighting the major issues. The comment letters have been prepared by a Task Force of NAREIT members and reviewed and approved by NAREIT's Best Financial Practices Council. The memo and comment letters are available in the Accounting Issues section of www.nareit.com. NAREIT staff is available to assist members identify issues to be included in a comment letter. The comment letter deadline has been extended to November 15, 2001.

NAREIT Issues Alert on Options Accounting

On September 17, 2001, NAREIT distributed a National Accounting Alert based on the FASB's August 2001 issuance of final guidance on the accounting for options used as hedges under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Known as Derivatives Implementation Group (DIG) Issue G20, *Cash Flow Hedges: Assessing and Measuring the Effectiveness of a Purchase Option Used in a Cash Flow Hedge*, this favorable guidance dramatically changes the way in which REITs and other real estate companies will account for options used as hedging instruments in financial statements.

Provided certain criteria are met, options can be considered fully effective hedging vehicles, with gains and losses due to changes in market value remaining on the balance sheet. Therefore, changes in market value will no longer cause volatility in earnings - both net income under generally accepted accounting principles (GAAP) and Funds From Operations (FFO). The following is a summary of what option holders should know about G20:

- The improved accounting applies to purchased options such as interest rate caps, zero cost collars, and option combinations that are net purchased options;
- Only cash flow hedging transactions benefit - transactions whereby companies convert the interest rates on loans from a floating rate to a certain fixed rate. The inverse are fair value hedges, the accounting for which is not improved by the G20 modifications;
- The earnings impacts will be known in advance. At the time of inception, option owners will obtain a schedule of fair 'caplet' values to the maturity of the hedge. This removes the uncertainty of option values that in the past have created unpredictable volatility in earnings. G20's modification to options accounting allows companies to easily project the extent to which an option's change in value would be reported in future earnings.
- For those options used in hedging risks associated with funding development projects, the premiums paid can be capitalized as a part of the project cost provided that the options are fully effective.
- Real estate companies and REITs that hold options can adopt this accounting immediately. G20 can be adopted as long as options are properly designated with updated documentation

NAREIT was instrumental in the FASB's adoption of a more favorable way of accounting for the "time value" of options used as interest rate hedges. In a May 2001 letter to the FASB, NAREIT strongly urged the Board to adopt these changes recommended by the Board's Derivatives Implementation Group (DIG). We would like to thank representatives of the accounting firms and Marti Tirinnanzi, Vice President, Chatham Financial Corporation and chair of NAREIT's Derivatives and Hedging Task Force, for their advice and support in NAREIT's achieving this result. A complete copy of the National Accounting Alert is available in the Accounting Issues section of www.nareit.com.

NAREIT To Issue National Policy Bulletin on Income Taxes

NAREIT's Best Financial Practices Council plans to shortly issue a National Policy Bulletin that discusses the need for information regarding taxable income and income taxes. With the creation and formation of taxable REIT subsidiaries (TRS), the importance of income taxes to users of financial statements will take on increased significance. The Council prepared the Bulletin to assist companies in the development of income tax disclosures required by SFAS 109, *Accounting for Income Taxes*, by providing examples of disclosures from current real estate company reports to shareholders.

In addition, some analysts and investors have suggested that REITs also should disclose a reconciliation of their GAAP net income with taxable income to provide investors with a better understanding of the dividends required to be paid, as well as the relationship between actual payouts and the required payout. REIT investors focus on dividends as a significant part of their return on investment and dividend payout ratios as a percentage of earnings to project the dividend-paying ability of a REIT. Despite the fact that taxable income effectively establishes dividend payouts for many REITs, this amount is not readily available from reporting under GAAP. Included in the Bulletin are examples of REIT disclosures reconciling GAAP net income with taxable income.

A complete copy of the Bulletin is available in the Accounting Issues section of www.nareit.com.

Update on FASB Activities

Costs of September 11 Events not Extraordinary

On September 28, 2001, the FASB's Emerging Issues Task Force (EITF) decided unanimously that losses related to the September 11 terrorist attacks should not be classified as extraordinary in the statement of operations. In recent weeks, the EITF has been wrestling with Issue 01-10, *Accounting for the Impact of the Terrorist Attacks of September 11, 2001.*

The conclusion represents a reversal of an earlier, tentative decision that concluded the attacks were "unusual and infrequent" and permitted certain losses to be reported as extraordinary items. In reaching this decision, the Task Force cited the difficulty in assessing the direct financial effects of the attacks from the prevailing economic conditions and applying guidelines consistently. By requiring all companies to include costs of the attacks as part of ongoing operations, subjectivity in the determination of what is ordinary and extraordinary would be eliminated.

Although the Task Force concluded that the events of September 11 were certainly "extraordinary," because the economic effects of the events were so extensive and pervasive they decided that it would be impossible to capture the entire effect in any one financial statement line item. By only showing part of the effect as extraordinary "would hinder, rather than help, effective communication."

Another consideration was that extraordinary treatment would never capture the largest "cost" many companies would suffer - lost revenue. The conclusion will allow companies to provide data in the form of pro forma results, as well as footnote disclosures and MD&A.

Issues Asset Impairment and Disposal Rules

On October 3, 2001, the FASB issued its new guidance on asset impairment and disposal. Statement 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, supersedes Statement 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. The new guidance establishes one accounting model for long-lived assets to be disposed and replaces the provisions of APB Opinion No. 30, *Reporting Results of Operations-Reporting the Effects of Disposal of a Segment of a Business*, for the disposal of segments of a business.
Notably, the final standard will permit either an expected cash flow or best-estimate approach for estimating future cash flows of

assets to be held and used. This change was requested in NAREIT's comment letter in response to the original proposal and in statements made at the Board's January 2001 Impairment Roundtable discussion. Under the new rules, long-lived assets to be disposed should be measured at the lower of carrying amount or fair value less cost to sell. The Statement also broadens the reporting of discontinued operations to include all components of an entity with operations that can be distinguished from the rest of the entity

The provisions of Statement 144 are to be applied prospectively in financial statements issued for fiscal years beginning after December 15, 2001. The new standard can be ordered on-line at www.fasb.org or by contacting the FASB's Order Department at 800-748-0659.

Issues Business Combinations Rules

On July 20, 2001, the FASB issued its long-awaited rules on accounting for business combinations, as well as related guidance on accounting for acquired goodwill and other intangible assets. Statement 141, B*usiness Combinations*, and Statement 142, *Goodwill and Other Intangible Assets*, were both published at the end of July. Under the new rules, the pooling-of-interests method of accounting is prohibited for business combinations initiated after June 30, 2001. The separate standard providing guidance for accounting for goodwill and other intangible assets reflects the FASB's decision to eliminate goodwill amortization and require periodic goodwill impairment testing. Impairment losses resulting from required transitional tests of impairment will be reported as a change in accounting principle. Calendar-year companies are required to adopt the new standard and cease goodwill amortization beginning in 2002. Copies of the new standards can be ordered on-line at www.fasb.org or from the FASB order department (800-748-0659).

EITF Reaches Conclusion on Integral Equipment

In July 2001, the FASB's Emerging Issues Task Force reached final consensus on Issue 00-11, *Lessors' Evaluation of Whether Leases of Certain Integral Equipment Meet the Ownership Transfer Requirements of FASB Statement No. 13, Accounting for Leases*. With the issuance of FASB Interpretation No. 43, *Real Estate Sales*, leasing transactions involving integral equipment are now considered to be leases of real estate. Equipment is considered integral if it is attached to real estate and cannot be removed and used separately without incurring significant cost. Guidance is intended to address the transfer of integral equipment, in accordance with a lease, without the concurrent transfer of the underlying real property, when such transfers are not subject to either a statutory title registration system or Article 2 of the Uniform Commercial Code (UCC).

Two issues were addressed:

1. Whether integral equipment subject to a lease should be evaluated as real estate under Statement 13.

2. If integral equipment subject to a lease is evaluated as real estate under Statement 13, how the requirement in paragraph 7(a) of Statement 13 for the transfer of ownership should be evaluated when no statutory title registration exists for the leased assets.

Paragraph 7(a) of Statement 13 includes one of four criteria for when a lease should be accounted for as a capital lease (i.e., sales-type lease for the lessor). Paragraph 7(a) provides that the lease be accounted for as a capital lease if the lease transfers ownership of the property to the lessee by the end of the lease term.

For the first issue, the EITF concluded that integral equipment subject to a lease should be evaluated as real estate under Statement 13, as amended by Statement 98. It was noted that Statement 98 was intended to conform the requirements of Statement 13 with respect to sales-type leases of real estate to the requirements of Statement 66 with respect to sales of real estate.

In the second issue, it was decided that for integral equipment or property improvements

for which no statutory title registration system exists, the criterion in paragraph 7(a) of Statement 13 is met in lease agreements that provide that, upon the lessee's performance in accordance with the terms of the lease, the lessor shall execute and deliver to the lessee such documents as may be required to release the equipment from the lease and to transfer ownership to the lessee. This criterion is also met in situations in which the lease agreement requires the payment by the lessee of a nominal amount in connection with the transfer of ownership. However, the criterion would not be met if the lease agreement contains a provision whereby ownership of the leased property is not transferred to the lessee if the lessee elects not to pay the specified fee (whether nominal or otherwise) to complete the transfer of the property. This provision would be considered a purchase option and would not satisfy criterion 7(a) of Statement 13.

The conclusions are applicable to (a) leases beginning after July 19, 2001, and (b) leases modified after July 19, 2001, that meet the criteria in paragraph 9 of Statement 13 to be considered new agreements. Companies should disclose the effect on the balance sheet and the income statement resulting from a change in lease classification under (b) for leases that at inception would have been classified differently had the guidance in Issue 00-11 been in effect at the inception of the original lease.

Considers New Agenda Projects

In August 2001, the FASB released information regarding the possible addition of two projects to its agenda - reporting financial performance and disclosure about intangible assets. The former project could have a significant impact on how items are reported in financial statements. It would seek to address concerns about the spread of pro forma earnings measures, as well as the lack of common definitions for financial performance and key financial measures or indicators of financial performance.

The latter project would seek to establish standards for improving disclosure of information about intangible assets that are not presently recognized as assets in financial statements. These would include intangible assets that are generated internally or written off immediately after being acquired. The primary goal of the project would be to provide new quantitative and qualitative information, with a secondary goal of initiating the development of a method for recognizing internally generated intangible assets in the financial statements.

In September, the panel that advises the FASB, the Financial Accounting Standards Advisory Council (FASAC), generally supported the project on reporting financial performance. This support was conditioned on the FASB limiting its rulemaking efforts to studying the feasibility of defining certain line items, subtotals and totals in future rules and requiring them to be shown in financial statements. Separately, the FASAC expressed concerns on the intangibles project regarding the practicability of measuring and valuing the assets.

Other rulemaking projects under consideration include defining liabilities and revenue recognition. The FASB plans to make decisions about new agenda items in upcoming months.

SEC Appoints New Chief Accountant

On September 19, 2001, the Securities and Exchange Commission announced that, on October 8, 2001, Robert K. Herdman would become Chief Accountant. In addition to overseeing and directing all of the SEC's accountants and accounting-related efforts, as well as interfacing with national and international accounting groups, Mr. Herdman will lead the SEC in revising and modernizing its accounting and financial disclosure system.

Mr. Herdman has been a CPA since 1971, spending 28 of the last 32 years with Ernst & Young. He currently is Vice-Chair of his firm, overseeing the professional practice of its Americas Assurance and Advisory Business Services. At E&Y, he has been the senior partner responsible for the firm's relationships with the SEC, the FASB, and the AICPA.

Prior to accepting the position with the SEC, on October 1, 2001, Mr. Herdman was to chair the AICPA's SEC Practice Section Executive Committee. From 1986 to 1992, he was a member of the FASB's EITF. He served on the SEC's staff as a Professional Accounting Fellow from 1982 to 1984. From 1974 to 1976 he was the Controller of a Fortune 1000 manufacturing company. His career began at E&Y in 1969 after receiving a B.S.C. from DePaul University.

NAREIT 2001 SFO Workshop; Investor Relations Workshop

Final arrangements are being made for NAREIT's 2001 Senior Financial Officers (SFO) Workshop to be held on December 3 & 4 in Philadelphia, Pennsylvania at the Park Hyatt Philadelphia. Sponsored by the five major accounting firms and Chatham Financial Corporation, the program will provide an opportunity for corporate members to discuss: the recent debates over the increased focus on GAAP earnings/EPS reporting by real estate companies; the financial impact and security issues related to September 11; capital recycling programs; optimizing the use of derivatives and hedging; executive level technology; and what's new in accounting standards proposals. Registration materials will be mailed to financial officers of NAREIT corporate members in mid October. If you would like to register early, you may register on-line at www.nareit.com/SFO.htm or call NAREIT at 202-739-9400 and a registration form will be faxed to you. Also, if you would like to attend and do not receive a brochure, please contact Natalie Williams at (202) 739-9443 or nwilliams@nareit.com.

This year NAREIT also is hosting an Investor Relations Workshop at the same location as, and just prior to, the SFO Workshop. Financial executives and IR executives are encouraged to attend the IR Workshop on Monday afternoon (December 3). Please make your lead IR person aware of this program. Separate materials will be sent to your IR executive. For more information, contact Rob Valero at 202-739-9439 or rvalero@nareit.com.

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