NAREIT Financial Standards Update

National Association of Real Estate Investment Trusts®
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Financial Standards Update

EITF to Examine the Accounting for the Sale of Real Estate to an Entity When the Agreement between the Investors Includes a Buy-Sell Clause

On July 20, 2007, the Financial Accounting Standards Board's (FASB) Emerging Issues Task Force (EITF) Agenda Committee (Committee) concluded that the EITF should examine the accounting for the sale of real estate to an entity when the agreement between the investors includes a buy-sell clause. The Committee's discussion and report is available by clicking HERE.

The issue presented in the Committee's report asks whether or not a buy-sell clause in the form presented below precludes partial sale and profit recognition pursuant to paragraph 26 of FAS 66 *Accounting for Sales of Real Estate* (that is, does it constitute an "option" or other form of prohibited continuing involvement?)

The Committee's description of a buy-sell clause that is the subject of this EITF examination is as follows:

> Buy-sell clauses provide investors with an exit strategy for closely held investments. Frequently, a buy-sell clause in the form described in the following paragraphs is included in an agreement between investors.
>
> Two investors (Investor A and Investor B) form an entity. Investor A sells real property to that entity. The agreement between the investors includes a buy-sell clause, which provides that either investor may request a buy-out of the other party's interest by providing notice (the "Purchase Notice") to the other party. The party providing Purchase Notice is referred to as the "Offeror" and the receiving party is the "Offeree."
>
> The Purchase Notice constitutes an irrevocable offer by the Offeror to buy the Offeree's entire interest in the entity. In the Purchase Notice, the Offeror names a price for the Offeree's equity at its discretion (the "Named Price"). Upon receipt of the Purchase Notice, the Offeree can elect to either sell its interest in the entity to the Offeror or buy the Offeror's interest.

Highlights

- EITF to Examine the Accounting for the Sale of Real Estate to an Entity When the Agreement between the Investors Includes a Buy-Sell Clause
- SEC Concept Release regarding the possibility of U.S issuers utilizing IFRS instead of U.S. GAAP
- FASB Tentative Conclusions on Accounting Changes for Certain Convertible Debt Could Increase Reported Interest Expense
- Global Real Estate Industry Coalition Reaches Consensus on a Global Financial Statement Model

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The Committee's report provides two accounting alternatives:

View A would preclude the investor/transferor from recognizing partial sale and profit at the time of the transfer if the agreement between the investors contains a buy-sell clause. Further, analogizing to Statement 98 *Accounting for Leases*, View A characterizes a buy-sell clause as a contingent option and, therefore, concludes that the clause should be treated as an option under FAS 66. If treated as an option, the buy-sell clause would preclude sale and profit recognition. Proponents of View A also analogize to guidance in EITF Issue No. 97-1 *Implementation Issues in Accounting for Lease Transactions, Including Those Involving Special Purpose Entities*.

View B, which reflects the great preponderance of current practice and NAREIT's position, holds that a buy-sell clause does not in and of itself constitute an option or other form of prohibited continuing involvement, which would preclude partial sale and profit recognition pursuant to Statement 66. Proponents of View B believe that a normal buy-sell clause does not meet the definition of an option because it does not convey unconditional rights. NAREIT strongly supports View B, which has been the basis of accounting for these sales/transfers for over 25 years.

In support of this work, we have distributed a survey to NAREIT member companies. If your company has not received the survey or have not yet completed it, we would appreciate it if you would click HERE and complete the survey by August 24. In addition to completing the brief survey, we are requesting that members send to us examples of standard buy-sell clauses.

The EITF will discuss this issue at its September 11, 2007 meeting. FASB staff has contacted us and requested NAREIT's views of current practice and of the accounting alternatives presented. NAREIT is forming a task force to examine this issue and develop a letter to the EITF. Any NAREIT member interested in participating on this task force should contact George Yungmann at gyungmann@nareit.com by the close of business on August 22.

SEC Concept Release Regarding the Possibility of U.S Issuers Utilizing IFRS Instead of U.S. GAAP

On August 7, 2007, the Securities and Exchange Commission (SEC) published *Concept Release 33-8831 Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards* (Release). The Release solicits information regarding the possibility of allowing U.S. issuers to report under International Financial Reporting Standards (IFRS) instead of U.S GAAP. The SEC has already received overwhelmingly favorable feedback with respect to this issue in initial communications with analysts, public accounting firms and companies. The SEC wants to gather information from a wider audience to ensure this monumental change would in fact positively impact U.S. markets.

In a question format, the Release inquires about a myriad of issues including whether a consistent application of IFRS is attainable versus the feared "multiplicity of standards under the same name."

Comments on the Release are due no later than November 13, 2007.

Background

In October 2002, the jointly issued Norwalk Agreement was released by the FASB and the International Accounting Standards Board (IASB). A subsequent Memorandum of Understanding outlines a plan to create compatible accounting standards that could be used for both domestic as well as cross-border financial reporting that would better serve investors and promote capital formation. The SEC anticipates that these new standards would enhance comparability, reduce regulatory burdens and costs, and increase access to foreign issuer investment opportunities for investors in the U.S. public capital markets. IFRS is used in almost one hundred countries, and many additional countries are transitioning to IFRS in lieu of their own countries' standards.

On a related note, the SEC published a proposal to eliminate the current requirement for foreign private issuers filing under IFRS to file a reconciliation from IFRS to U.S. GAAP. This proposal can be found HERE. The SEC's latest activities related to this project can be found HERE.

NAREIT is forming a task of members to evaluate the SEC proposal relating to U.S. issuers and consider commenting on them. If you would like to participate in this task force, please contact Andrea Perlak at aperlak@nareit.com.

FASB Tentative Conclusions on Accounting Changes for Certain Convertible Debt Could Increase Reported Interest Expense

In a pivotal FASB meeting on July 25, the FASB formally agreed to pursue a project that aims to change the accounting for convertible debt that may be settled either wholly or partially in cash. Changes put forward in EITF Issue 07-2 *Accounting for Convertible Debt Instruments That Require or Permit Partial Cash Settlement Upon Conversion* could substantially change accounting for these popular debt instruments. Because the EITF could not reach a consensus, the FASB will consider issuing an FASB Staff Position (FSP) on this accounting issue. If the Board's preliminary decisions are adopted, companies would be required to account for debt and equity components of these instruments separately. This change in accounting could affect Net Income and Funds From Operations (FFO), perhaps materially. We have been advised that NAREIT member companies have issued at least $20 billion of this type of debt.

The new accounting methodology generally would result in a substantially higher recorded interest expense when compared to the expense based on current practice. The Board's tentative conclusions would require that debt be recorded at its fair value as determined by reference to a similar bond without the conversion attached. The difference between the recorded fair value of the debt and the nominal value of the debt would be recorded as debt discount and additional paid-in-capital. The liability would be accreted up to its par value over the life of the loan.

Again, these tentative conclusions of the FASB could cause a substantial increase in reported interest expense. For example, if the carrying amount of the debt is $500 million, after recording a debt discount related to the conversion feature, and the difference between the stated interest rate and the "economic cost" of the debt is 300 basis points, interest expense could increase by over $10 million. The actual increase would depend on the original amount of the debt and the amount of the debt discount.

The tentative FASB conclusions would be effective for all periods beginning after December 15, 2007, or January 1, 2008 for calendar year companies, and would require retroactive application of the final standard. Accordingly, both new, as well as existing, debt would have to be accounted for under the new guidance (no grandfather clause) in all periods presented in the financial statements for periods beginning the first quarter of 2008. FASB expects an exposure draft (ED) of a proposed FSP to be issued in late August, 2007 with a 45 day comment period. Click HERE for a staff paper that was the basis for the Board's July 25, 2007 discussion.

NAREIT is establishing a task force of NAREIT members to evaluate the ED and consider submitting a comment letter. If you are interested in participating on this task force, please contact Andrea Perlak at aperlak@nareit.com.

Global Real Estate Industry Coalition Reaches Consensus on a Global Financial Statement Model

Over the past two years, NAREIT has been working with a coalition of real estate organizations from around the world toward developing the content and form of a global financial statement model. This financial statement model has been developed in connection with the joint FASB/IASB *Financial Statement Presentation* project, and will provide the basis for the industry's input to this project.

On August 9, the coalition reached a consensus on the model, which represents a landmark achievement for the global real estate industry. The model contains: a) a statement of comprehensive income; b) a statement of changes in shareholders' equity; c) a statement of cash flow; and, d) a statement of financial position. A majority of the coalition efforts focused on the content and format of the statement of comprehensive income. The consensus reached includes consolidated metrics similar to what the U.S. industry currently labels "net operating income" and "funds from operations."

The tentative consensus model reached in May 2007 has been discussed with NAREIT's Best Financial Practices Council and Executive Committee. Over the past two months, the other coalition members have also obtained input from their respective leadership and accounting committees. The current consensus model reflects many of the views expressed by these groups. On

Aug. 16, NAREIT's Executive Committee approved the final model.

Organizations represented in the coalition include:

- Asian Public Real Estate Association
- British Property Federation
- European Public Real Estate Association
- National Association of Real Estate Investment Trusts
- Property Council of Australia
- Real Property Association of Canada

On a related note, NAREIT has agreed to lead the development of an industry paper designed to describe the real estate industry to the FASB and IASB. The paper will include a broad discussion of the industry, its economics, sources of capital, investor perspectives and needs, lender underwriting criteria, credit rating perspectives and financial reporting issues. The paper would be used as background for communications with the Boards on various topics.

IFRIC Exposure Draft D-21 Real Estate Sales

The IASB's International Financial Reporting Interpretations Committee (IFRIC) has issued an exposure draft, D-21 *Real Estate Sales* (ED), which, if adopted in the U.S., could negatively impact a REIT's ability to recognize gains on sales of investment property that: a) are sold through merchant building operations; or b) are sales to a joint venture or an investment fund. We have received input from NAREIT's Accounting Committee and other members that this interpretation as written would restrict gain recognition.

Three specific concerns were voiced by the NAREIT Accounting Committee. First, one of the requirements of revenue recognition identified in the ED is that the "entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold." This raises a question as to whether a sale and profit may be recognized by the seller of real estate when the seller enters into an agreement to manage the property subsequent to the sale. Second, the ED does not explicitly address partial sales. Finally, the guidance in the ED may impact certain build-to-suit transactions when the buyer has significant influence on the design of the building.

The IFRIC Standards in the ED would be applied in accounting for revenue from the sale of real estate for entities utilizing IFRS. It addresses three main points:

1) The meaning of the term "construction contract" as defined by IAS 11 versus a "sale of goods;"
2) The conditions that must be met before the selling entity recognizes revenue for the sale of real estate; and,
3) The way in which the selling entity should recognize and measure any contractual obligations that remain when the conditions for recognizing revenue have been met.

The document can be found HERE.

NAREIT is forming a task force to examine this issue and develop a comment letter to the IFRIC. Any NAREIT member interested in participating on this task force should contact George Yungmann at gyungmann@nareit.com.

AICPA Issues a Guide for Investment Company Accounting that Could Impact Certain REITs and Affiliates

On June 11, 2007, the AICPA issued SOP 07-1 *Clarification of the Scope of the Audit and Accounting Guide "Investment Companies" and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (SOP). The SOP provides criteria for determining whether an entity must apply the special accounting included in the Guide. The special accounting includes the requirement to report investment property at fair value.

The Guide defines an investment company as an entity "whose business purpose and activity are investing in multiple substantive investments for current income, capital appreciation, or both, with investment plans that include exit strategies." The entity's assets, liabilities and activities are limited to investment purposes. The SOP explicitly states that "involvement in the day-to-day management of investees, their affiliates or other investment assets by the entity or its affiliates provides evidence that the entity is investing for strategic operating purposes" and, therefore, the entity would generally not be considered an investment company.

REITs and real estate operating companies that manage their investment properties may well not be considered investment companies, but others may fall within the scope of the SOP. This may be the case when an affiliate, *e.g.*, a joint venture or an investment fund, meets the criteria defining an investment company. Further, it appears that the special accounting would not generally be included in the consolidated financial statements of the REIT even when an affiliate prepares reports based on the SOP. A brief summary of the SOP is available by clicking HERE. We suggest that you discuss any questions concerning the SOP or its potential application to your company or its affiliates with your accounting firm.

FASB Examining Fair Value Reporting for Investment Property

In the context of its *Fair Value Option* project, the FASB has provided under the Phase I standard, FAS 159 *Fair Value Option for Financial Assets and Financial Liabilities*, the opportunity to report certain equity method investments in unconsolidated affiliates, including many real estate joint ventures, at fair value. In Phase II of the project, the FASB is examining whether to provide an option to report investment property at fair value. In examining this question, the Board will consider the standards set forth in IAS 40 *Investment Properties*, which requires that the fair value of investment property be reported either in the balance sheet or notes to the financial statements.

NAREIT's comment letter on the Phase I exposure draft is available by clicking HERE. NAREIT intends to meet with the FASB this fall to share its views on reporting investment property at fair value.

FASB Proposal Clarifies Requirements for Applying Short-cut Hedge Accounting

On July 24, the FASB issued proposed Statement 133 Implementation Issue No. E23 *Issues Involving the Application of the Shortcut Method under Paragraph* 68. This proposal is designed to eliminate inconsistent application of the shortcut method and improve comparability in financial statements. Click HERE to access this proposal. The shortcut method is a widely used and efficient method of simplifying hedge accounting. It assumes that the change in value of the swap is equal to the change in value of the hedged item, eliminating complex calculations and the need to report income volatility. The proposed standard sets forth the required attributes of a hedge that must exist in order for a company to apply the short-cut methodology.

The comment period will expire on September 21, 2007. Please contact Andrea Perlak at aperlak@nareit.com with any comments or questions.

Sarbanes-Oxley Audit Standard Adopted and New Concept Release Issued for Comment

On July 25, 2007, the SEC formally approved the adoption of the Public Company Accounting Oversight Board's (PCAOB) proposed Auditing Standard No. 5 (AS 5), *An Audit of Internal Control over Financial Reporting That is Integrated with an Audit of Financial Statements*. The new standard takes unprecedented steps towards eliminating ambiguity that inadvertently caused unnecessary costs and hindered the relationship between auditors and their clients. The standard allows but does not require Section 404 audits and evaluations to be increasingly risk-based. The risk-based approach promotes a process that is "scalable to company size and complexity." Auditing Standard No. 5 replaces PCAOB Auditing Standard No. 2.

"In approving (the standard), the Commission has strengthened investor protection by refocusing resources on what truly matters to the integrity of financial statements. This is an exceptionally positive step for both investors and for America's capital markets," said SEC Chairman Christopher Cox.

SEC Chairman Christopher Cox

The SEC notes several key changes:

1. Auditing Standard No. 5 is purposely less prescriptive in order to allow the auditor to focus on areas that are, in their view, higher risk.

2. Auditing Standard No. 5 attempts to make the "audit scalable so it can change to fit the size and complexity of any company."

3. Auditing Standard No. 5 directs auditors to focus on the highest risk areas and encourages the auditor to eliminate unnecessary procedures from the audit.

4. Auditing Standard No. 5 allows the auditor to "apply professional judgment in determining the extent to which (the auditor may) use the work of others."

The new standard can be found HERE.

In addition to the approval of AS 5, the SEC issued a concept release that provides additional guidance on managements report on internal controls over financial reporting. It addresses concerns regarding risk and control identification, management's evaluation, documentation requirements, information sharing and other hot-button topics. The guidance should be especially helpful to non-accelerated small filers that are required to begin reporting on internal controls beginning in 2008.

The concept release also requests input from constituents on a variety of topics including whether additional guidance is needed on how to evaluate the effectiveness of a company's internal control structure and what type of evaluation approaches have managements found most effective. After carefully evaluating AS 5 and this concept release, NAREIT has determined that both documents respond to NAREIT's most important previous comments to the PCAOB and SEC and, therefore, it is not necessary to issue a comment letter on this additional proposal. The comment period covering the SEC concept release closes on September 9. The concept release is available HERE. If you are aware of any additional concerns, please contact Andrea Perlak at aperlak@nareit.com.

Convergence Effort Continues as FASB/IASB Merge U.S. and IFRS Tax Rules

This project is a part of the original IASB/ FASB convergence project plan defined by the Memorandum of Understanding. Both the IASB and FASB are examining a number of convergence issues. NAREIT was contacted by the FASB staff as they focused on how REITs and other companies subject to unique tax structures that eliminate "double taxation" apply FAS 109 *Income Taxes*. After several discussions with the FASB staff and based on tentative decisions of the IASB and FASB, we do not believe this project will impact the current practices in accounting for income taxes by REITs, however, we are monitoring this project closely. Click HERE to access information on the FASB's work on this project.

The project will not alter the basic approach utilized by both standards, FAS 109 *Accounting for Income Taxes* and IAS 12 *Income Taxes*. Instead, the convergence effort intends to eliminate the numerous exceptions that create differences in application of the standards. The project plan endorses the temporary difference approach set forth in current guidance that is described by the IASB as recognizing "deferred tax assets and liabilities for temporary differences (differences between the carrying amount of an asset or liability in the balance sheet and its tax base) and for operating loss and tax credit carryforwards."

On July 19, the IASB reached tentative conclusions on the few remaining issues outstanding in a joint effort to merge the standards. The major decisions made by the IASB include the treatment of investment tax credits, special deductions and calculations involving expected rates of tax.

The FASB will examine certain remaining convergence issues over the next few months and issue an exposure draft in tandem with the IASB exposure draft in the fourth quarter of 2007.

For more information on the IASB's work on this project click HERE .

Upcoming NAREIT Financial Standards Events:

Retail Sector Operations Accounting Forum

Building on the inaugural success of the Retail Sector Operations Accounting Forum held in August 2006 in Cleveland, NAREIT's Second Annual Retail Sector Operations Accounting Forum will be held August 28 and 29, 2007 in Jacksonville, FL exclusively for NAREIT corporate members. To date, over 50 retail sector financial managers have registered for this forum. We want to thank Kimco and Regency for agreeing to sponsor this event. If you are interested in attending this event, please contact Kristin Bahny at kbahny@nareit.com.

Internal Auditor Forum

NAREIT's 2007 Internal Auditor Forum will be held in Santa Monica, California, on August 21 and 22. We want to thank Macerich for agreeing to sponsor this event, which will be held at its headquarters office. The program is designed exclusively for individuals from NAREIT corporate members who direct the internal audit function. Participants in previous years' Forums have found this event very helpful in managing their companies' internal audit function. Program and registration information can be obtained by contacting Kristin Bahny at kbahny@nareit.com.

Senior Financial Officer/Investor Relations Officer Workshop

The 2007 SFO/IRO Workshop is scheduled for September 24 and 25 and will be held at the Marriott Financial Center Hotel in New York. The workshop will feature a special risk management session and financial management and investor relations roundtables. Sessions will focus on:

- the latest trends and opportunities in the real estate capital markets;
- the latest developments in the financial reporting area;
- take-aways for year-end financial reporting;
- reaching investors in a new digital age;
- capital investment analysis;
- views of investors and analysts on REIT valuations;
- leveraging technology; and other timely topics.

The workshop is designed for financial managers, investor relations officers and risk managers of NAREIT corporate members. Further details on the workshop and registration materials are available by contacting Kristin Bahny at kbahny@nareit.com.

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