NAREIT Financial Standards Update

National Association of Real Estate Investment Trusts®
REITs: Building Dividends and Diversification®

Financial Standards Update

FASB and IASB to Develop New Lease Accounting Standards that Could Dramatically Impact Lessor Industry Reporting

On July 19, the Financial Accounting Standards Board (FASB) formally added to its agenda a project to reconsider the current accounting standards for leases. Most participants in the financial reporting arena agree that current lease accounting does not clearly portray the resources and obligations arising from many lease transactions, especially for lessees. The most significant concern is that, for leases that currently qualify as "operating leases," the lessees' assets (rights to use property) and related obligations are not recognized in financial statements. A recent report issued by the Securities and Exchange Commission (SEC) suggests that $1.25 trillion of lessee obligations are not reflected in balance sheets.

Of major concern to our industry and other lessors is whether new standards will re-characterize investment property on the balance sheet and/or re-characterize rents reported in lessors' income statements.

The goal of the lease accounting project is to ensure that investors and other users of financial statements are provided useful, transparent, and complete information about leasing transactions. New standards will be developed in a joint project with the International Accounting Standards Board (IASB). In approving the project, the FASB's consensus was that both lessee and lessor accounting should be considered but that, if lessor accounting issues slow progress, the FASB would consider expediting the issuance of new standards for lessee accounting.

The FASB and IASB will organize a joint international working group in 2006 to provide input on the issues to be considered. Deliberations of those issues will begin in 2007 and result in the issuance of a preliminary views document in 2008 for public comment.

As part of its due diligence, the FASB invited NAREIT to meet with its manager of the lease accounting project and other senior staff

Highlights

© Copyright 2006
National Association of Real Estate Investment Trusts®
REITs: Building Dividends and Diversification®
1875 I Street, NW, Suite 600, Washington, D.C. 20006-5413 • 202-739-9400, 800-3NAREIT • 202-739-9401 fax
www.nareit.com • www.investinreits.com

www.nareit.com

members. George Yungmann and Gaurav Agarwal met with the FASB staff and one FASB board member on July 14 and provided the industry's initial views on lease accounting issues. NAREIT discussed a number of accounting issues that the FASB should consider from a landlord's or the lessor's point of view. NAREIT intends to nominate an industry representative to serve on the joint international working group to provide industry input directly into this project. Click HERE for the FASB release on this topic.

FASB Issues Final Interpretation on Uncertain Tax Positions

On July 13, the FASB issued FIN 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 increases the relevancy and comparability of financial reporting by clarifying the way companies account for uncertainty in measuring income taxes. Currently, the accounting for uncertainty in income taxes, which is based upon the sustainability of a tax position, is subject to significant and varied interpretations that have resulted in diverse and inconsistent accounting practices and measurements.

Accordingly, FIN 48 prescribes a consistent recognition threshold and measurement attribute, as well as clear criteria for subsequently recognizing, derecognizing and measuring tax positions for financial statement purposes. Essentially, FIN 48 only allows a favorable tax position to be included in the calculation of tax liabilities and expenses if a company concludes that it is more likely than not that its adopted tax position will prevail if challenged by tax authorities. Click HERE for the full text of FIN 48.

FIN 48 is effective for fiscal years beginning after Dec. 15, 2006. NAREIT's views were reflected in the comment letter submitted by The Tax Council, a national organization representing large public U.S. companies. These views were also reflected in a comment letter filed by the Financial Executives International.

International Accounting Standards Board®

IASB Proposes Converging Guidance on Borrowing Costs

On May 25, the IASB published an exposure draft aimed at improving the accounting for borrowing costs. The proposal would amend International Accounting Standard 23, *Borrowing Costs* (IAS 23) and harmonize the accounting for such costs with the U.S. GAAP guidance provided in Statement of Financial Accounting Standards No. 34, *Capitalization of Interest Cost.*

The amendments would eliminate a major difference between the two standards' accounting treatments for borrowing costs. Borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset would have to be capitalized as part of the asset's cost. Previously IAS 23 allowed a choice to capitalize or expense such costs. The majority of real estate companies routinely capitalize borrowing costs incurred during construction of property.

NAREIT is currently working with a coalition of international real estate organizations to express to the IASB global real estate industry support for the proposed amendments to IAS 23 that would remove the choice of expensing such costs. Click HERE to access the exposure draft.

www.investinreits.com

NAREIT Issues Alert on Accounting for Modifications to Stock Award Plans

On May 25, NAREIT issued a Financial Standards Alert which discusses a specific issue related to the FASB's Statement of Financial Accounting Standard No.123(R), *Share Based Payments* (FAS 123R). FAS 123R became effective on Jan. 1, 2006 for most public companies, including REITs. Among other guidance, the FAS 123R provides guidance on accounting for stock awards (options, restricted stock or other awards) and modifications to the terms of stock award agreements.

The major accounting firms have advised NAREIT that FAS 123R requires that, when: 1) the terms of a stock award arrangement are modified in connection with a dilutive equity event, *e.g.*, stock split, stock dividend, rights offering or special dividend, including modifications that are designed to make the award holder whole and, 2) and the company is not required to make such adjustments under the terms of the award plan or agreement, then the company must account for the change as a plan modification. This modification treatment will generally result in expensing of incremental compensation cost. However, these firms advise us that amending a stock award plan or agreement to require modification of the terms of agreements upon a dilutive equity event, but not in contemplation of such an event generally should not result in incremental compensation expense.

Companies may want to examine their stock option plans/agreements to ensure that they reflect the intentions of the board of directors or compensation committee with respect to modifying the terms of stock award plans/agreements in connection with dilutive equity events. Further, companies may want to discuss the accounting for modifications to the terms of their plans/agreements with their outside accounting firm. Click HERE to access NAREIT's Alert.

www.nareit.com

NAREIT Submits Letter to FASB on Discontinued Operations Reporting

In a letter dated July 17, NAREIT requested that the FASB reconsider whether the disposition of investment property should generally be reported in discontinued operations. Based on the industry's experience in applying Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144), over 10 fiscal quarters, including the negative impacts of this reporting on the ability of investors and analysts to predict future earnings and the communications complexities faced by our member companies in the international business arena, NAREIT requested that the FASB consider issuing some form of guidance that would explicitly provide for judgment in determining whether the disposition of assets should be reported in discontinued operations. Click HERE for NAREIT's 2006 letter.

You may recall that, NAREIT had provided its views to the FASB as it developed SFAS 144. Further, in a follow-up letter dated Dec. 27, 2001, NAREIT raised concerns regarding the standard and guidance as it was thought to apply to REITs and other entities that manage portfolios of investment property. Specifically, NAREIT expressed concern that the notion of "**significant** components" [emphasis added] was not carried forward from the exposure draft and that absent this notion, the regular/continuous reclassification of operating results from continuing to discontinued operations would create considerable complexity and confusion among users of our industry's financial statements. The 2001 letter further discussed the industry's concern that many accountants suggested that, since the final standard did not explicitly provide for a notion of significance, most dispositions of investment property (even individual properties) would be required to be reported as discontinued operations.

The 2001 letter further indicated that this application of the standard would create considerable confusion among financial statement users. NAREIT requested that the FASB clarify, in SFAS 144, its intention "to allow for judgment in determining whether, based on facts and circumstances unique to a particular entity, a disposal transaction should be reported in discontinued operations." At that time, the FASB concluded that no further guidance was necessary.

NAREIT's 2006 letter reiterates many of the same concerns noted in prior letters and also raises the issue of inconsistency with International Financial Reporting Standard No. 5, *Non-Current Assets Held for Sale and Discontinued Operations.* As part of the current initiative, NAREIT's staff met with certain FASB board members and expressed the industry's concerns to them in person. The FASB has committed to conduct its own independent research and get back to us in the near future.

SEC Seeks Feedback on SARBOX

On July 11, the SEC published a concept release as a prelude to its forthcoming guidance for management in assessing a company's internal controls for financial reporting.

Following its May 10 roundtable devoted to Sarbanes-Oxley Section 404 implementation issues, the SEC issued a roadmap for improvements entitled "Next Steps for Sarbanes-Oxley Implementation." The issuance of the concept release is one of the milestones on that roadmap, and it brings the SEC one step closer to issuing guidance for management that has been lacking since the law was enacted in 2002.

www.investinreits.com

www.nareit.com

At the roundtable, the SEC learned from participants that, while Section 404 has produced benefits, its implementation has been unduly costly. The SEC also received specific feedback about issues that remain to be addressed, and actions that the SEC and the Public Company Accounting Oversight Board could take to make the internal control assessment and auditing more efficient and more effective. A separate Advisory Committee on Smaller Public Companies reported that companies, which have not yet undertaken the process, have special concerns with both costs and procedures. The planned guidance for management, which is the subject of the concept release, is intended to assist in dealing with all of these issues and concerns.

The SEC anticipates that the forthcoming guidance for management will cover at least these areas:

- Identifying risks to financial statement account and disclosure accuracy and the related internal controls that address the risks, including how management might use company-level controls to address the risks.
- Objectives of the evaluation procedures and methods or approaches available to management to gather evidence to support its assessment.
- Factors management should consider in determining the nature, timing, and extent of its evaluation procedures.
- Documentation requirements, including overall objectives of the documentation and factors that might influence documentation requirements.

The concept release seeks feedback on each of these topics and on whether guidance should be provided in other areas as well. The comments are due by the second week of September and the release can be accessed by clicking HERE. Please contact George Yungmann if you would like to participate in NAREIT's consideration of this release and the development of comments that would be filed with the SEC.

FAF Board Appoints New Member to the FASB

On May 16, the Board of Trustees of the Financial Accounting Foundation (FAF) announced that Thomas J. Linsmeier will become a member of the FASB effective July 1, 2006. Mr. Linsmeier succeeds current FASB member Katherine Schipper, whose term expired on June 30. Mr. Linsmeier was the Russell E. Palmer Endowed Professor and Chairman of the Department of Accounting and Information Systems in the Eli Broad College of Business at Michigan State University. Click HERE to access FASB's press release announcing the appointment.

COSO Issues Final Report on Applying Internal-Control Framework to Smaller Companies

On July 8, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released its final report: *Internal Control over Financial Reporting - Guidance for Smaller Public Companies.* The report contains guidance on the use of COSO's framework to address the needs of smaller businesses in fulfilling the requirements of Section 404 of the Sarbanes-Oxley Act.

The report does not provide a new COSO framework for smaller companies, but instead takes the existing COSO framework for internal controls and tailors it to smaller companies, which might not have the resources of large companies. One of the report's core themes is that the hands-on approach of management at smaller businesses can result in less formal controls without

www.investinreits.com

www.nareit.com

compromising quality. This guidance was developed by a task force led by PricewaterhouseCoopers, at the request of the SEC, which believes that this guidance will help smaller companies to efficiently and effectively implement the Section 404 requirements and also help companies of all sizes to understand and apply the fundamental concepts in COSO's internal control framework. Click HERE to obtain the full report.

SEC Adopts Changes to Disclosure Requirements Concerning Executive Compensation

On July 26, the SEC voted to adopt changes to the rules requiring disclosure of executive and director compensation, related person transactions, director independence and other corporate governance matters, and security ownership of officers and directors. These changes will affect disclosure in proxy statements, annual reports and registration statements, as well as the current reporting of compensation arrangements. Further, the rules require that the disclosures be provided in plain English.

The amendments will refine the currently required tabular disclosure and combine it with improved narrative disclosure to elicit clearer and more complete disclosure of compensation of the principal executive officer, principal financial officer, the three other highest paid executive officers and the directors. Also, new "Compensation Discussion and Analysis" disclosures will provide plain-English narrative descriptions of the objectives and policies underlying executive compensation programs.

Click HERE for the SEC release.

Gaurav Agarwal to Leave NAREIT

After nearly four years at NAREIT, Gaurav Agarwal has decided to pursue other opportunities. Gaurav will be joining Sunrise Senior Living in McLean, VA as their senior director of accounting policy. For many of you, Gaurav has been the main point of contact for accounting, finance, SARBOX, and FFO related questions and queries, as well as meetings/forums such as the Internal Audit Forum. Gaurav's last day at NAREIT will be Aug. 18. In Gaurav's absence, you may direct your queries to George Yungmann. We wish Gaurav the best of luck in his new position and thank him for his many contributions to NAREIT.

NAREIT
Steven A. Wechsler
President and CEO
(202) 739-9400, swechsler@nareit.com
Policy and Politics
Tony M. Edwards
Executive Vice President and General Counsel
(202) 739-9408, tedwards@nareit.com
Financial Standards Team

George L. Yungmann
Sr. Vice President,
Financial Standards
(202) 739-9432
gyungmann@nareit.com
Gaurav Agarwal
Sr. Director, Financial
Standards
(202) 739-9442
gagarwal@nareit.com

NAREIT® does not intend this publication to be a solicitation related to any particular company, nor does it intend to provide investment, legal or tax advice. Investors should consult with their own investment, legal or tax advisers regarding the appropriateness of investing in any of the securities or investment strategies discussed in this publication. Nothing herein should be construed to be an endorsement by NAREIT of any specific company or products or as an offer to sell or a solicitation to buy any security or other financial instrument or to participate in any trading strategy. NAREIT expressly disclaims any liability for the accuracy, timeliness or completeness of data in this publication. Unless otherwise indicated, all data are derived from, and apply only to, publicly traded securities. All values are unaudited and subject to revision. Any investment returns or performance data (past, hypothetical, or otherwise) are not necessarily indicative of future returns or performance. © Copyright 2006 National Association of Real Estate Investment Trusts®. NAREIT® is the exclusive registered trademark of the National Association of Real Estate Investment Trusts.

www.investinreits.com