NAREIT Financial Standards Update

January 2004

NAREIT Financial Standards Update

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

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NAREIT

Meeting with FASB Regarding AcSEC's Proposed PP&E (Cost Capitalization) SOP

On November 25, 2003, NAREIT staff and representatives from member REITs met with the FASB and its staff to express our industry's concerns regarding the AICPA's Accounting Standards Executive Committee's (AcSEC) proposed Statement of Position (SOP), *Accounting For Certain Costs And Activities Relating To Property, Plant, And Equipment*. Our conversation emphasized NAREIT's views, expressed in a July 9, 2003 letter to Bob Herz, Chairman of FASB, that the proposed SOP: (1) would lead to greater, rather than lesser, diversity in practice; (2) is at serious odds with the harmonization of U.S. accounting standards with global standards; (3) would treat an investment property as an amalgamation of hundreds of physical components rather than an integrated economic entity; and (4) would increase the cost of administering property assets with virtually no offsetting benefit to financial statement users. In addition, we discussed the possibility of the industry using realistic salvage values in the calculation of investment property depreciation. Click **HERE** to access NAREIT's letter to the FASB.

Comments on FASB Staff Position on FIN 46

At its December 17, 2003 meeting, the FASB approved a partial deferral of FIN 46 to reports on the first quarter of 2004. As reported in the January 2003 *Financial Standards Update*, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46) in January 2003. FIN 46 governs when an investor must consolidate an investee's financial statements in its consolidated financial statements. Prior to FIN 46, consolidation was

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generally triggered if an investor held an ownership interest in a jointly owned entity and directly or indirectly controlled the entity. The rule, a direct response to the Enron and other corporate debacles, requires that an investor evaluate each jointly owned entity, including projected cash flows, to determine which investor carries the greatest economic exposure (especially on the downside). The partner with the greatest economic exposure (especially on the downside) must consolidate the VIE. Items such as preferred returns, back-end promotional fees and funding of significant capital expenditures are likely to trigger consolidation.

The rule was initially effective for the third quarter of 2003 financial statements. In response to widespread concern that companies were unable to complete a thorough evaluation of existing variable interest entities, the FASB proposed deferring the application to the fourth quarter 2003 financial statements. In its comment letter dated October 7, 2003, NAREIT supported the deferral of the effective date of FIN 46 for variable interests held by a public entity until at least the end of the first interim or annual period ending after December 15, 2003. Click **HERE** to access NAREIT's comment letter.

There are various categories and sub-categories for effective dates. While the application of the Board's deferral must be considered in the context of the facts and circumstances of each arrangement underlying our members' entities, our understanding is that this deferral covers the great majority of the NAREIT member companies. This is based on our presumption that the majority of our member owned entities are not special purpose entities and were created prior to February 1, 2003. Click **HERE** to access the FASB meeting minutes discussing this deferral.

Achieves Deferral of SFAS 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, as Applied to Many Industry Transactions

At its October 29, 2003 meeting, the FASB voted to generally defer indefinitely the application of paragraphs 9 and 10 of SFAS 150 to non-controlling (minority) interests in finite-life entities. As reported in the May 2003 *Financial Standards Update*, the FASB issued SFAS 150 in May 2003. SFAS 150, as then interpreted by many practitioners, would have required that minority interests in consolidated jointly owned entities that have a fixed termination date be reported in the parent's consolidated balance sheet as liabilities. Further, SFAS 150 required that the minority interest liability be reported at "settlement value" - the amount of cash or other assets that would be required to liquidate the minority interest liability - at each balance sheet date. Period-to-period increases and decreases in the liability's settlement value would have been reported as increases and decreases, respectively, in interest expense.

In order to mitigate the impact of this interpretation of SFAS 150 on the real estate industry, NAREIT and many of its members wrote to the FASB. In its letter dated October 7, 2003, NAREIT explained that as then being interpreted, SFAS 150 would significantly impact the real estate industry. Further, the impact of SFAS 150 on the industry's financial reporting would have been exacerbated by the implementation of FIN 46, which will increase the extent to which the industry will be required to report minority interests in consolidated entities. Click **HERE** to access NAREIT's comment letter.

NAREIT also indicated in its letter to the FASB

that SFAS 150 would produce an anomalous result of requiring the minority interest liability to be adjusted to settlement value based on the fair value of the jointly owned entity's underlying assets that continue to be carried at historical cost in the consolidated financial statements. Said more simply, the very changes in asset value that create the recognized adjustments to the SFAS 150-minority interest liability would not be themselves reflected in the parent's consolidated financial statements. NAREIT and numerous member companies requested that the Board urgently address this inappropriate financial reporting result.

Comments on IASB Proposal on Disposal of Non-current Assets and Presentation of Discontinued Operations

NAREIT's September 2003 *Financial Standards Update* indicated that the International Accounting Standards Board (IASB) had made available an exposure draft of its proposed International Financial Reporting Standard, *Disposal of Non-current Assets and Presentation of Discontinued Operations* (ED 4). Click **HERE** to access the exposure draft. The IASB issued this exposure draft as it considers FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144) to further the convergence of accounting standards around the world.

In its comment letter dated October 20, 2003, NAREIT supported the Board's efforts to converge accounting standards around the world.

However, in response to Question 8, *Classification as a discontinued operation,* we indicated that it is not appropriate for comparative financial statements to be restated every time a company disposes a property. We reiterated that treating all dispositions as discontinued operations and, therefore, constantly restating previously reported operating results, causes a great deal of confusion to financial statement users. Our comment letter suggested that the rules of classification as a discontinued operation should only apply to significant components of an entity's business and not to individual sales of long-term assets. Click **HERE** to access NAREIT's comment letter.

Comments on SEC Proposal on Security Holder Director Nominations

On December 22, 2003, NAREIT filed comments with the SEC regarding security holder director nominations. NAREIT's comments were in response to an SEC proposal that would, under certain circumstances, require public companies to include in their proxy materials security holder nominees for election as director. In our comments, we sought clarification on the notice requirement and conflicts with corporate bylaws and state laws. Additionally, we asked the Commission to include a phase-in period for any final rule. Click **HERE** to access NAREIT's comment letter.

FASB

Issues Standard on Disclosures about Pensions and Other Post-retirement Benefits

On December 23, 2003, the FASB issued Statement No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits*, which expands financial statement disclosures for defined benefit plans. The project was initiated by the FASB earlier this year in response to concerns raised by investors and other users of financial statements about the need for greater transparency of pension information. The change replaces existing FASB disclosure requirements for pensions. In an effort

to provide the public with better and more complete information, the standard requires that companies provide more details about their plan assets, benefit obligations, cash flows, benefit costs and other relevant information.

For the first time, companies are required to provide financial statement users with a breakdown of plan assets by category, such as equity, debt and real estate. A description of investment policies and strategies and target allocation percentages, or target ranges, for these asset categories also are required in financial statements. Cash flows will include projections of future benefit payments and an estimate of contributions to be made in the next year to fund pension and other post-retirement benefit plans.

In addition to expanded annual disclosures, the FASB is expanding the information available to investors in interim financial statements. Companies are required to report the various elements of pension and other post-retirement benefit costs on a quarterly basis.

The guidance is effective for fiscal years ending after December 15, 2003, and for quarters beginning after December 15, 2003. Click **HERE** for the complete text of the statement.

Issues Exposure Drafts to Improve Accounting Guidance and Support Convergence of Global Accounting Standards

In December 2003, the FASB issued four Exposure Drafts (EDs) that seek to improve U.S. generally accepted accounting principles and converge U.S. accounting guidance with existing international accounting standards.

The EDs reflect the progress that the FASB and IASB have made on a first phase of a joint short-term convergence project that was initiated in 2002. The short-term convergence project involves both the FASB and IASB comparing existing standards and conforming the two sets of standards to the higher-quality solution.

The comment period for the EDs ends on April 13, 2004. Please contact George Yungmann or Gaurav Agarwal if you feel that any of these EDs discussed below may have an impact on your financial reporting and if you would like to participate in developing a NAREIT comment letter on any of them. Please give particular attention to the changes in accounting for non-monetary transactions. For example, we are interested in your input on if and how this change would impact accounting for like kind exchanges under section 1031 of the Internal Revenue Code.

The EDs are summarized below:

Accounting Changes and Error Corrections– a replacement of APB Opinion No. 20 and FASB Statement No. 3: This proposed Statement would change the reporting of certain accounting changes specified in APB Opinion No. 20, *Accounting Changes*, which requires that most changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to a new accounting principle. This proposed Statement would require retrospective application for changes in accounting principle, unless it is impracticable to determine either the cumulative effect or the period-specific effects of the change. When it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented, this proposed Statement would require that the new accounting policy be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable, and that a corresponding

adjustment be made to the opening balance of retained earnings (or other appropriate balance sheet caption) for that period. When it is impracticable for an entity to determine the cumulative effect of applying a change in accounting principle to all prior periods, this proposed Statement would require the new accounting principle to be applied as if it were made prospectively from the earliest date practicable.

This proposed Statement would apply to changes in an accounting principle required by issuance of new pronouncements of the FASB and other standard-setting bodies, unless a new pronouncement contains other specific transition guidance.

Of particular importance to our industry, this proposed Statement would require that a change in depreciation method be accounted for as a change in accounting estimate and not as a change in accounting principle.

Please click **HERE** to access the full text of the ED.

Exchanges of Productive Assets – an amendment of APB Opinion No. 29: This proposed Statement would eliminate paragraph 21(b) of APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, which establishes an exception to the general principle that exchanges of nonmonetary assets should be recorded at the fair value of the assets exchanged. Paragraph 21(b) concludes that non-monetary exchanges of "similar productive assets" should not result in gain recognition because the earnings process has not been culminated. This proposed Statement would eliminate the concept of "similar productive assets" and require that nonmonetary exchanges of productive assets be accounted for based on the fair values of the assets involved, unless the exchange transaction does not have commercial substance. An exchange would be deemed to have commercial substance if a) the configuration (risk, timing or amount) of the expected future cash flows of the asset(s) received differs from the configuration of the expected future cash flows of the asset(s) transferred, or b) the entity-specific value of the portion of the reporting entity's operations affected by the transaction changes as a result of the exchange, and either of these changes are significant. If a transaction were not deemed to have commercial substance, then the asset received would be accounted for at the cost basis of the asset given up. Further, the current exception to fair value accounting for nonmonetary exchanges of productive assets for which the fair value of neither the asset received nor the asset surrendered is determinable within reasonable limits remains unchanged by this proposed Statement. Click **HERE** to access the full text of the ED.

Earnings per Share – an amendment of FASB Statement No. 128: This proposed Statement would amend the computational guidance of FASB Statement No. 128, *Earnings per Share*. When applying the treasury stock method for year-to-date diluted earnings per share (EPS), Statement 128 requires that the number of incremental shares included in the denominator be determined by computing a year-to-date weighted average of the number of incremental shares included in each quarterly diluted EPS computation. Under this proposed Statement, the number of incremental shares included in year-to-date diluted EPS would be computed using the average market price of common shares for the year-to-date period. This proposed Statement also would eliminate the provisions of Statement 128 that allow an entity to rebut the

presumption that contracts with the option of settling in either cash or stock will be settled in stock. Finally, this proposed Statement would require that shares to be issued upon conversion of a mandatorily convertible security be included in the computation of basic EPS from the date that conversion becomes mandatory. Click **HERE** to access the full text of the ED.

Inventory Costs– an amendment of ARB No. 43, Chapter 4: This proposed Statement would adopt wording from the International Accounting Standards Board's (IASB) IAS 2, Inventories, for portions of ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, Chapter 4, "Inventory Pricing," relating to inventory pricing. The IASB believes ARB 43, Chapter 4, and IAS 2 have the same intent; however, differences in the wording of the two standards could lead to inconsistent application of their principles. Paragraph 5 of ARB 43, Chapter 4, states that ". . . under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges. . . ." By adopting the language of IAS 2, those items would be classified as current-period charges, regardless of whether they met the criterion of "so abnormal." Click **HERE** to access the full text of the ED. This proposed amendment to U.S. GAAP could impact the accounting of those member companies that develop real estate for sale, *e.g*. community development, merchant building etc.

PCAOB

Proposes Auditing Standards for Internal Control over Financial Reporting

On October 7, 2003, the Public Company Accounting Oversight Board (PCAOB) unanimously voted to issue a proposed standard on audits of internal control over financial reporting. The auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, addresses both the work that is required to audit internal control over financial reporting and the relationship of that audit to the audit of the financial statements. Click **HERE** to access the standard. The integrated audit results in two audit opinions: one on internal control over financial reporting and one on the financial statements.

Section 404(a) of the Sarbanes-Oxley Act of 2002 (Act), and the SEC's related implementing rules, require the management of a public company to assess the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year. Section 404 of the Act also requires management to include in the company's annual report to shareholders, management's conclusion, as a result of that assessment, about whether the company's internal controls are effective. Section 404 of the Act, as well as Section 103, directs the PCAOB to establish professional standards governing the independent auditor's attestation and reporting on management's assessment of the effectiveness of internal control.

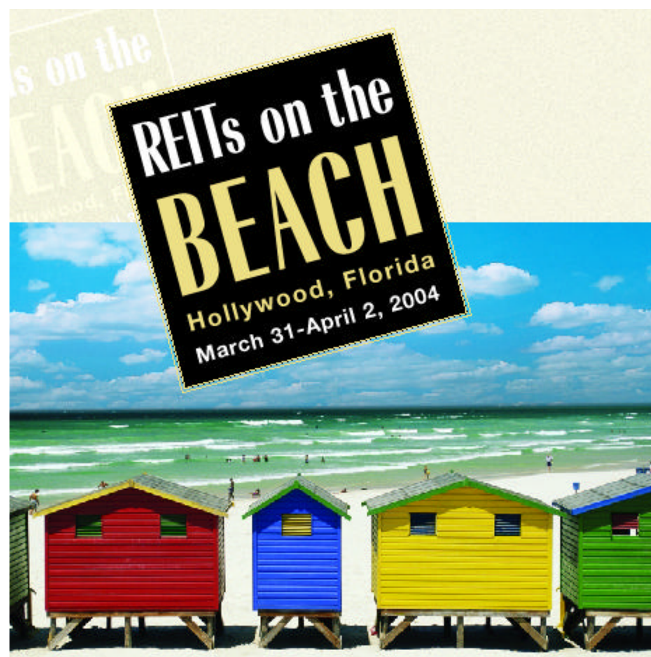
While the effective dates for complying with Section 404 rules vary based on whether or not a company is an accelerated filer, most NAREIT member companies must begin to comply with the management report on internal control over financial reporting disclosure requirements in their annual reports as of the end of their first fiscal year ending on or after June 15, 2004. Therefore, most NAREIT member companies must begin to comply with the requirements regarding evaluation of any material change to its

internal control over financial reporting in first quarter 2005 quarterly reports.

The proposed standard requires the auditor to communicate in writing to the company's audit committee all significant deficiencies and material weaknesses of which the auditor is aware. The auditor also is required to communicate in writing to the company's management all internal control deficiencies of which he or she is aware and to notify the audit committee that such communication has been made. One of the more controversial proposals in the standard requires the auditor to evaluate factors related to whether the audit committee is effective, including whether audit committee members act independently from management.

NAREIT 2004 Law & Accounting Conference

NAREIT's Law & Accounting Conference will be held this year in Hollywood, Florida at the Westin Diplomat. It is scheduled a month earlier (March 31-April 2, 2004) to better avoid conflicts with the great majority of member companies' earnings calls and annual meetings. NAREIT thanks David Brandon from KPMG, Alex Rubin from Merrill Lynch, Dawn Severt from Gables Residential, and Bruce Strohm from Equity Residential for serving as Program Directors. The program is nearing completion and will include discussions of topics that are timely and relevant to executives, attorneys and accountants associated with the real estate industry. Click **HERE** to register for the conference.



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