December 2004

NAREIT Financial Standards Update

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

In this issue:

FASB

Delays the Implementation Date for Expensing Stock Options

On October 17, 2004, the Financial Accounting Standards Board (FASB) decided to delay the effective date of its standard entitled *Share-Based Payment*. The delay comes at the request of several constituents, including the staff of the Securities and Exchange Commission (SEC). The standard's effective date will apply to awards that are granted, modified or settled in cash in interim or annual periods beginning after June 15, 2005 (the originally proposed effective date had been January 1, 2005). The FASB issued its final standard, *Share-Based Payment (Revised 2004)*, on December 16, 2004. Click HERE to access the final standard.

EITF Considers Partnership Consolidation Rules That Could Increase Consolidation of Joint Ventures

For many years, financial statement preparers and auditors have debated how to evaluate whether a partnership should be consolidated by one of its partners. Recent guidance provided in FASB Interpretation No. 46 (R), *Consolidation of Variable Interest Entities* (FIN 46 (R)), regarding "kick-out" rights in the context of evaluating variable interests and consolidation of variable interest entities, has renewed the debate over what considerations are relevant in making that

1875 Eye Street NW, Suite 600, Washington, DC 20006-5413 • 202-739-9400, 800-3NAREIT • 202-739-9401 fax • www.nareit.com

evaluation. A particular focus is when should the general partner consolidate a limited partnership that is not considered a variable interest entity.

Currently, the question of whether such a partnership should be consolidated by one of its partners is typically addressed by analogizing to the guidance in AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures* (SOP 78-9). This SOP specifically provides guidance on the accounting for investments in real estate ventures including investments in corporate joint ventures, general partnerships, limited partnerships and undivided interests. The current issue is whether rights held by the limited partner(s) preclude consolidation when the sole general partner would otherwise consolidate the limited partnership.

For the past several months, FASB's Emerging Issues Task Force (EITF) has been debating EITF Issue 04-5, *"Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Rights."* At the November 2004 meeting, the Task Force reached a tentative conclusion that a sole general partner is presumed to control a limited partnership and should consolidate the limited partnership unless, based on a two-step analysis, that presumption is overcome. The tentative conclusion indicates that a general partner should consolidate a limited partnership unless: 1) the limited partners possess substantive "kick-out" rights as defined in paragraph B20 of FIN 46(R); or, 2) the limited partners possess substantive participating rights similar to the rights described in EITF Issue 96-16, *"Investor's Accounting for an Investee When the Investor has a Majority Shareholder or Shareholders Have Certain Approval or Veto Rights."* It appears that a similar analysis and result would apply with respect to a company's membership in a limited liability company.

The tentative conclusion will be issued as a draft abstract and exposed for comment with the expectation that comments could be considered and a consensus reached at the March 2005 meeting. The tentative effective date for this guidance would be for fiscal years beginning after December 15, 2005. If the tentative conclusion in this issue becomes a consensus at a future meeting, the number of limited partnerships that are consolidated by sole general partners is likely to increase. If you would like to participate on a task force to comment on this issue, please contact Gaurav Agarwal. Click HERE to access the current draft abstract.

SEC

Postpones Final Phase-in Period for Annual and Quarterly Reports for Accelerated Filers

On November 17, 2004, the SEC issued a final rule that postpones by one year the final phase-in period for filing of quarterly and annual reports by public companies that are accelerated filers. The deadline for these companies to file their annual reports for fiscal years ending on or after December 15, 2004 will remain at 75 days after fiscal year end. Similarly, the filing deadline for the subsequent year's quarterly reports will remain at 40 days after quarter end. The final phase-in period for accelerating filing will then resume, with a 60-day deadline for annual reports for fiscal years ending on or after December 15, 2005 and a 35-day deadline for subsequent quarterly reports.

Commission rules define an "accelerated filer" as a company that: 1) has a public float of at least $75 million; 2) has been subject to the SEC's periodic reporting requirements for at least 12 months and has filed one annual report; and, 3) is not eligible to use the SEC's small business reporting forms. The primary purpose of the postponement is to give accelerated filers and their auditors more time to comply with the new internal control reporting requirements set forth in Section 404 of the Sarbanes-Oxley Act of 2002. Click HERE to access the press release announcing the final rule.

Postpones Filing Date for Internal Control Reports for Some Accelerated Filers

On November 30, 2004, the SEC issued an exemptive order to grant certain accelerated filers up to an additional 45 days to include in their annual reports the management's report on internal control over financial reporting and the related auditor's report on management's assessment of internal control over financial reporting. Based on the criteria discussed below, a number of NAREIT member companies will not be required to file these internal reports until Monday, May 2, 2005.

As you know, both internal control reports are required under SEC rules implementing Section 404 of the Sarbanes-Oxley Act of 2002. All other information required in annual reports, including audited financial statements, would have to be filed on the original due date for the annual reports, which is 75 days after the company's fiscal year end. Those filers that meet the exemption criterion will need to file an amended annual report (Form 10 K/A) within 120 days of the fiscal year end that includes these internal control reports.

The exemptive order applies to an accelerated filer that has a fiscal year ending between and including November 15, 2004 and February 28, 2005, and that had a public equity float of less than $700 million at the end of its second fiscal quarter in 2004. Public equity float per the order is defined as, "the market value of the accelerated filer's outstanding common equity held by non-affiliates." Click HERE to access the full text of the exemptive order.

NAREIT

Comments on FASB's Draft EITF Abstract on Discontinued Operations

On October 14, 2004, the staff of the FASB released for public comment a draft abstract of EITF Issue No. 03-13, "Applying the Conditions in Paragraph 42 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, in Determining Whether to Report Discontinued Operations" (Issue 03-13). In this issue, the EITF is developing guidance with respect to discontinued operations that addresses: 1) how an entity should evaluate whether the operations and cash flows of a disposed component have been or will be eliminated; and, (2) the types of continuing involvement that constitute significant continuing involvement in the operations of the disposed component.

NAREIT reviewed the draft abstract and believed that the current application of FASB Statement No. 144 to real estate companies that own and operate investment property creates an issue that is very similar to the conceptual and reporting issues that the abstract addresses. The fundamental issue is that the cash inflows and/or outflows eliminated by dispositions of many investment properties are replaced through the acquisition of like-kind properties and, therefore, reporting these regular dispositions as discontinued operations does not faithfully represent the financial impact of the business transaction on the reporting entity. NAREIT's comment letter dated November 1, 2004 to the EITF set forth the industry's continuing concerns with this aspect of FASB Statement No. 144. Click HERE to access NAREIT's comment letter. Click HERE to access the draft abstract.

The consensus at the November 2004 EITF meeting is largely unchanged from the draft abstract, and when effective, the consensus will not provide relief to the real estate industry regarding the reporting of discontinued operations.

Meets with Members of the IASB

Both the FASB and SEC are committed to the harmonization of international and U.S. accounting standards and, therefore, there is a high probability that international accounting standards will eventually impact the U.S. real estate industry's financial reporting. In order for NAREIT to effectively advocate industry views in the international standards setting arena and the harmonization process, NAREIT staff and financial executives from certain member companies recently met with International Accounting Standards Board (IASB) representatives.

At a meeting on October 19, 2004, discussions covered the IASB's standards setting process and NAREIT's primary interest in certain international standards, *e.g.*, reporting investment property at fair value. On November 1, 2004, NAREIT staff and representatives from the European Public Real Estate Association (EPRA) met with IASB representatives to discuss questions regarding the application of certain standards to real estate company financial reporting.
In addition to the international standard requiring the disclosure of the fair value of investment property, the IASB/FASB joint project that would establish standards for the presentation of information in the financial statements could have important implications for the industry's financial reporting. The first meeting of an international working group will be held at the IASB offices in January. NAREIT staff will observe this meeting.

In connection with this standard setting project, NAREIT intends to establish a task force to develop a recommended model statement of operating performance that would guide NAREIT comments on proposals that will be issued by the IASB/FASB. Click HERE for information regarding this project. NAREIT members who are interested in joining this task force should contact George Yungmann.

Seeks SEC Comments From Members

Over the past two years, NAREIT staff has received an increasing number of member requests for information and guidance with respect to SEC comments on filed financial information. Members are generally seeking any available background on the comments, whether other NAREIT member companies have received similar comments, clarification of industry accounting and reporting practices, and, if available, how comments were resolved.

To enhance NAREIT staff's ability to provide this membership assistance, we are asking that members send SEC comments and, when available, resolutions to NAREIT. Information submitted will be used without communicating the identity of the company providing such information. If you have any questions regarding this request, please contact Gaurav Agarwal.

OTHER

Moody's Issues Report Discussing the Impact of Section 404 Material Weaknesses

As we are all aware, beginning with annual reports for the year ended 2004, companies will for the first time report on the effectiveness of internal control over financial reporting as required by Section 404 of the Sarbanes-Oxley Act of 2002. It is possible that companies could report material weaknesses in internal control, the most serious type of control deficiency. The existence of one or more material weaknesses will require management and the auditor to conclude that internal control over financial reporting is not effective. Such a conclusion, however, will not result in any sanctions or penalties from the SEC, provided the auditor issues an unqualified (clean) opinion on the financial statements. Many NAREIT members are currently contemplating what impact, if any, the existence of material weaknesses might have on their credit ratings.

Attached is a Moody's Special Comment report that provides its perspective on these issues.

BREAKING NEWS:

FASB Releases Three New Standards

On December 16, 2004, the FASB released the following three final standards:

1) Statement of Financial Accounting Standard No. 153, *Exchanges of Nonmonetary Assets-an amendment of APB Opinion No. 29 (SFAS 153)*. Click HERE to access the full text. The guidance in APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in that Opinion, however, included certain exceptions to that principle. This Statement amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for financial statements for fiscal periods beginning after June 15, 2005, and the provisions will be applied prospectively. Click HERE to access NAREIT's comment letter dated April 14, 2004, which agreed with the FASB that nonmonetary exchanges of real estate should be accounted for based on the fair values of the assets exchanged if the exchanges have commercial substance.

2) Statement of Financial Accounting Standard No. 152, *Accounting for Real Estate Time-Sharing Transactions-an amendment of FASB Statements No. 66 and 67 (SFAS 152)*. Click HERE to access the full text. SFAS 152 amends FASB Statement No. 66, *Accounting for Sales of Real Estate*, to reference the financial accounting and reporting guidance for real estate time-sharing transactions that is provided in AICPA Statement

of Position (SOP) 04-2, *Accounting for Real Estate Time-Sharing Transactions*. This Statement also amends FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to state that the guidance for (a) incidental operations and (b) costs incurred to sell real estate projects does not apply to real estate time-sharing transactions. The accounting for those operations and costs is subject to the guidance in SOP 04-2. SFAS 152 is effective for financial statements for fiscal years beginning after June 15, 2005. Restatement of previously issued financial statements is not permitted.

3) Statement of Financial Accounting Standard No. 123 (revised 2004), *Share-Based Payment (SFAS 123(R))* revises standards for reporting the cost of stock options. Click HERE to access the full text of the rule. Click HERE to access NAREIT's comment letter dated June 30, 2004. In our comment letter, we agreed with the FASB that employee services received in exchange for equity instruments give rise to recognizable compensation cost and that such costs should be recognized in the financial statements at their fair value. For most public REITs, as well as all public companies whose fiscal year coincides with the calendar year, the Statement will be effective beginning in the third quarter of 2005.

NAREIT
Steven A. Wechsler
President and CEO
(202) 739-9400, swechsler@nareit.com
Financial Standards/SEC Team
Tony M. Edwards
Senior Vice President and General Counsel
(202) 739-9408, tedwards@nareit.com
George L. Yungmann
Vice President, Financial Standards
(202) 739-9432, gyungmann@nareit.com
Gaurav Agarwal
Director, Financial Standards
(202) 739-9442, gagarwal@nareit.com