NAREIT

Real Estate Accounting Quarterly

April 2000

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Meeting Notice

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What: NAREIT Accounting Committee
Where: Law & Accounting Conference
Doral Golf Resort & Spa, Miami, Florida - Pavillion D
When: Wednesday, May 17, 1:30 - 3:00 pm

FFO Clarification Effective for First-Quarter Reporting

The clarification of Funds From Operations (FFO) approved by NAREIT's leadership in October 1999 is effective for all periods beginning on or after January 1, 2000. With the first quarter of 2000 being the initial period in which companies should report FFO in conformance with the clarification, NAREIT thought it would be beneficial to reiterate certain parts of the related November 8, 1999, National Policy Bulletin:

- The industry supplemental performance measure should include both recurring and non-recurring operating results - except those results defined as "extraordinary items" under generally accepted accounting principles (GAAP), as well as gains and losses from sales of depreciable operating property and certain undepreciated property (see comments below);

- Calculation of FFO based on the clarification should be shown for all periods presented in financial statements or tables;

- Disclosures should include the information recommended in the White Paper; and

- The underlying premise of the definition of FFO is not to sanction deviations from GAAP in the name of calculating Funds From Operations. The definition specifically refers to GAAP net income as the starting point in the calculation of FFO (i.e., all revenues and expenses included in FFO should be measured in accordance with GAAP).

As further clarified in Section III.B., *Treatment of Non-recurring and Extraordinary Items*, of the October 1999 White Paper on Funds From Operations (the White Paper), "FFO will continue to exclude the earnings impacts of cumulative effects of accounting changes and results of discontinued operations - both defined by GAAP."

Some industry participants have raised the question as to whether the clarification changed the treatment of gains and losses from the sale of undepreciated property incidental to a company's main business, most often sales of securities or parcels of land peripheral to operating properties. As stated in Section III.E., *Gains and Losses on Property Sales*, of the White Paper, "the prohibition against the inclusion of gains or losses on property sales in FFO was not meant to address this kind of activity, but rather the gain or loss on previously depreciated operating properties." The White Paper allows companies to choose whether to include such gains or losses from the sale of securities or land in FFO. Companies choosing to include such gains or losses in FFO should disclose the amount of such gains or losses, and those that do not should address the amount of such gains or losses in the reconciliation of net income to FFO.

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AcSEC and SEC Agree to Expand Scope of Proposed Cost Capitalization SOP; NAREIT Task Force Submits Comments

NAREIT's Cost Capitalization Task Force was formed in 1999 to provide input to the Accounting Standards Executive Committee (AcSEC) of the AICPA as it develops an accounting standard (Statement of Position or SOP) that would distinguish which expenditures related to real estate should be capitalized or expensed. In early March 2000, the Securities and Exchange Commission (SEC) and AcSEC agreed to expand the scope of this project to include the capitalization accounting practices for property, plant and equipment for all industries, as well as the accounting for costs related to major repairs and maintenance expenditures (also known as overhauls and turnaround costs). Assuming the Financial Accounting Standards Board (FASB) concurs with the project's expansion, an exposure draft is expected in December 2000, with a final standard in August 2001. NAREIT's Task Force does not expect this development to materially change its plans.

In January 2000, NAREIT Staff attended AcSEC's first public meeting in which AcSEC's Cost Capitalization Task Force presented its initial issues in the development of a SOP, including:

1. Criteria for Capitalization versus Expense
2. Accounting for Acquisition, Development, and Construction (ADC) Costs, Including Indirect and Overhead Costs
3. Component Accounting
4. Classification of Certain Costs as Prepaid Expenses
5. Inclusion of Lessees in Scope
6. Accounting for Contractually Recoverable Capital Expenditures

NAREIT's Task Force submitted a comment letter (available under Accounting Issues in the Members Only section of www.nareit.com) to the AcSEC Task Force addressing each of these issues. NAREIT would like to thank its task force for its assistance, especially Pam Bruno (BNP Residential Properties), the task force's chair.

The conclusions reached in this project could have a significant impact on reporting operating results (both GAAP net income and FFO) of REITs and other real estate companies. In addition to potentially restricting costs that can be capitalized, the new standard may require that all costs of real estate projects be accounted for by components. This would require that any component that may need replacement or overhaul before the end of the property's useful life be accounted for separately. This could include many parts of an investment property, such as a roof, HVAC equipment, elevators, escalators, carpet, etc. Further, the proposal as currently drafted would limit the capitalization of certain indirect and overhead costs.

To assist the AcSEC Task Force, NAREIT's Task Force is preparing to conduct a survey of the industry by sector to determine capitalization practices by type of expenditure, including minimum dollar threshold for capitalization and useful lives used in the calculation of depreciation. Our survey also will seek information on accounting for indirect costs and contractually recoverable capital expenditures.

IASC Adopts "Free Choice" Fair Value Accounting for Investment Property

At its March 2000 meeting, the International Accounting Standards Committee (IASC) approved IAS 40, *Investment Property*, permitting a "free choice" between fair value and historical cost reporting for investment property. Under the fair value model, changes in fair value should be recognized in earnings. Significantly, companies that choose the historical cost basis (IAS 16, *Property, Plant and Equipment*) would be required to provide a footnote disclosure of the fair value of investment property.

IAS 40 applies to investment property held by all companies, not just those entities whose main activity is ownership of property for rental and/or capital appreciation. Further, the accounting model chosen would be required to be applied on a company-wide basis, not by individual property or groups of properties. The new standard is effective for periods beginning on or after January 1, 2000, although earlier application is encouraged.

FASB Issues Employee Stock Options Rules

On March 31, 2000, the FASB issued

Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, its interpretation of APB Opinion No. 25, *Accounting for Stock Issued to Employees*. As expected, the interpretation carves out a special exception so that stock awards granted to outside directors fall under the advantageous accounting provisions of APB 25 (i.e., no compensation expense is recognized). On another significant issue, a repricing of a stock award would trigger variable-plan accounting and recognition of compensation expense. However, recognition of compensation expense is required prospectively after July 1, 2000 (the effective date of the interpretation) for repricings that took place subsequent to December 15, 1998. The report is available from the FASB Order Department at (800) 748-0659.

FASB Issues Concepts Statement on Present Value Accounting

In February 2000, the FASB issued Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. The statement provides a framework for the use of future cash flows and present value, especially when the amount of the future cash flows and their timing are uncertain. The framework includes the use of probabilities assigned to expected future cash flows to develop present values (i.e., a fair value) as the basis for an accounting measurement. Certain accounting standards require that real estate assets be measured at fair value. In situations where future cash flows are used in the measurement of fair value, this statement would provide guidance. The statement is available from the FASB Order Department at (800) 748-0659.

NAREIT Task Forces Submit Industry Responses to FASB

Derivatives and Hedging Proposal

On April 3, 2000, NAREIT's Derivatives and Hedging Task Force submitted an industry comment letter in connection with the FASB's proposed amendments to SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The new derivatives accounting standard will become effective in 2001 for calendar-year companies. The amendments are intended to reduce implementation difficulties.

In its submission, NAREIT's Task Force supported the FASB's proposals for normal purchases and normal sales exception, hedging recognized foreign currency denominated debt instruments, and hedging with inter-company derivatives, but expressed certain concerns about the proposals related to hedging the benchmark interest rate and the accounting for the discontinuation of cash flow hedges.

- Hedging the benchmark interest rate - The proposal would permit the benchmark interest rate to be designated as the hedged risk in a hedge of interest rate risk. However, the permitted benchmarks are limited and may not reflect other benchmarks that are customarily used by real estate companies in these types of transactions.

- Discontinuation of cash flow hedges - The proposal would allow a two-month time window beyond the initial time frame of a forecasted transaction for a derivative to qualify for hedge accounting. The task force expressed its concern that this window may not be sufficient when considering the process a real estate company may undertake to interact with civic groups, work through the entitlement process, and construct a building, and requested that an exception be provided for unforeseen circumstances.

The Task Force's comment letter can be found under Accounting Issues in the Members Only section of www.nareit.com. NAREIT wishes to thank the task force and its chair, Marti Tirinnanzi (Chatham Financial).

Joint Ventures Special Report

In January 2000, NAREIT formed a Joint Ventures Task Force to respond to financial standards proposals, and to consider developing industry best practices disclosures.

Phase one of the task force was completed in February 2000 upon the submission of a comment letter in response to the FASB's Special Report on *Reporting Interests in Joint Ventures and Similar Arrangements*. This report was issued in connection with the FASB's membership on the G4+1 group of accounting standards boards, comprised of representatives from the standard-setting bodies in Australia, Canada, New Zealand, the U.K., and the U.S.,

plus the International Accounting Standards Committee (IASC) as observers. An objective of the G4+1 group is to achieve convergence of financial reporting standards so that the information is more useful to cross-border capital market participants.

Attempting to address a wide diversity in standards and practice, the report provides a definition of joint venture for accounting purposes and how it may be distinguished from other forms of joint arrangements. It also proposes using the equity method of accounting for joint ventures, rather than the use of proportionate consolidation as permitted in some countries. Appropriate disclosures of interests in joint ventures and other forms of joint arrangements also are presented.

Although the Special Report will not initially lead to new accounting standards, because our members' business dealings regularly and increasingly involve the use of joint ventures, our task force supported the FASB's efforts to enhance the usefulness and relevance of financial reporting by developing international consensus on financial standards. Through discussions with our members, we discovered there is a diversity of opinion regarding a preference for the equity or proportionate share methods of accounting for joint ventures. Some members agree with the Special Report's conclusion that the equity method of accounting is the most appropriate method based on current financial reporting concepts, but believe that enhanced disclosures are necessary. Other members, especially credit and equity analysts, favor the proportionate share method of reporting and believe that the Special Report's conclusion is inconsistent with the objective of providing relevant information to financial statement users.

Regardless of the method of accounting ultimately promulgated, our members agree that sufficient disclosures should be required that will provide users with a better understanding of the financial statement elements related to joint venture investments. The Task Force's comment letter can be found under Accounting Issues in the Members Only section of www.nareit.com. NAREIT wishes to thank the task force for its assistance.

This task force also will draft a comment letter upon issuance of an exposure draft by the AcSEC intended to clarify and expand SOP 78-9, *Accounting for Investments in Real Estate Ventures*. The SOP will provide guidance on reporting unincorporated ventures, as well as address inconsistent practices in the areas of loss recognition. The AcSEC currently is redrafting the proposal for submission to the FASB seeking clearance for its issuance as an exposure draft. Anyone interested in joining this task force should contact David Taube at (202) 739-9442 or dtaube@nareit.com.

NAREIT to Form Task Force for G4+1 Special Report on Leases

In connection with the FASB's membership on the G4+1 group of accounting standards boards, it has issued a Special Report titled *Leases: Implementation of a New Approach*. The February 2000 report examines the principles that should determine the extent of assets and liabilities that lessors and lessees would recognize on the balance sheet at the inception of a lease. It also considers how those principles might be applied to account for many of the features that are found in lease contracts.

Although lease accounting is not on the FASB's agenda, this report provides the industry an opportunity to forward its views. The deadline for comment is July 31, 2000. The report is available from the FASB Order Department at (800) 748-0659.

NAREIT is forming a task force to consider preparing an industry comment letter. Anyone interested in participating should contact David Taube at (202) 739-9442 or dtaube@nareit.com.

SEC Activities

SEC Amends SAB on Contingent Rents

As discussed in the last Real Estate Accounting Quarterly, in December 1999 the SEC issued Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*, clarifying generally accepted accounting principles (GAAP) related to accounting for contingent rental revenues. As it relates to real estate companies, SAB 101 specifies that contingent rental income should be recognized as revenue only when the specific target that triggers the contingent income is achieved. NAREIT's National Policy Bulletin

on SAB 101 can be found under Accounting Issues in the Members Only section of www.nareit.com.

On March 24, 2000, the SEC issued SAB No. 101A, amending SAB 101. The amendment permits deferral of the implementation of SAB 101 for registrants with fiscal years that begin between December 16, 1999 and March 15, 2000, from the first quarter to the second quarter of such fiscal year. For example, companies with a December 31 year-end may defer implementation of SAB 101 from the first quarter to the second quarter of 2000.

As a reminder, the clarified definition of Funds From Operations (FFO) adopted by NAREIT in October 1999 (effective for all periods beginning on or after January 1, 2000) requires that FFO be calculated based on GAAP; including accounting for contingent rents in accordance with SABs 101 and 101A. However, any "cumulative effect" resulting from this change in accounting should not be included in FFO. The full text of SAB 101A can be found at http://www.sec.gov/rules/acctreps/sab101a1.htm.

SEC Plans New Supplemental Financial Disclosures; NAREIT Submits Comment

In January 2000, the SEC issued a proposal to reinstate a rule (rescinded in 1995) that required registrants to provide detailed schedules of property, plant and equipment, as well as related accumulated depreciation, depletion and amortization, where the combined amount of the property accounts exceeded 25% of the registrant's total assets. The new proposal also requires that all registrants disclose salvage values used in the measurement of depreciation expense.

Separately, the proposal would clarify and expand supplemental disclosure requirements concerning activities involving valuation and loss accrual accounts related to allowances and contingencies. The proposal would reposition these items from Schedule II of Regulation S-X to the Supplementary Financial Information section of Regulation S-K, thereby encouraging narrative disclosures about the assumptions underlying the recognition of a valuation or loss accrual account.

Since a substantial portion of our members' companies business consists of acquiring and holding for investment, interests in real estate, pursuant to Regulation S-X, they continue to be required to file with each annual report a "Schedule of Real Estate and Accumulated Depreciation" (a/k/a Schedule III). Because part of the proposal relates to tangible long-lived assets, in its comment letter NAREIT supported the SEC's proposal to reinstate the rules and to require information regarding salvage value, as the disclosures may provide for a more realistic evaluation of salvage values used in measuring periodic depreciation charges. NAREIT's comment letter can be found under Accounting Issues in the Members Only section of www.nareit.com.

SEC Issues Concept Release on IAS

In February 2000, the SEC issued a Concept Release regarding the acceptance of International Accounting Standards (IAS) and the broader issue of shaping a global financial structure for enhancing cross-border capital markets. A global financial structure could provide a way for companies using IAS to list their shares on U.S. stock exchanges. This release is relevant to REITs and other real estate companies because the newly adopted IAS 40 requires companies to report the fair value of investment property either in the financial statements or footnotes.

The Concept Release seeks comments on very broad issues, especially from preparers and users that have direct experience with financial statements that are based on IAS. NAREIT plans to use this opportunity to focus a comment letter on issues related to accounting for investment property. Specifically, the letter could discuss the Investment Property IAS in order to support the use of fair value in the measurement of salvage value for purposes of calculating depreciation. The comment period deadline is May 23, 2000. Anyone interested in participating in preparing NAREIT's comment letter should contact David Taube at (202) 739-9442 or dtaube@nareit.com.

Auditing Standards Board Issues New Rules

In December 1999, the AICPA's Auditing Standards Board (ASB) issued Statement on Auditing Standard No. 89, *Audit Adjustments*,

which, in part, requires an auditor to inform an entity's audit committee about misstatements aggregated by the auditor that management does not correct because it believes they are immaterial to the financial statements taken as a whole. SAS No. 89 is effective for audits of financial statements for periods beginning on or after December 15, 1999. Early adoption is permitted.

The ASB also has issued SAS No. 90, *Audit Committee Communications*, amending SAS No. 61, *Communication With Audit Committees*, and SAS No. 71, *Interim Financial Information*. The new standard is in response to recommendations in the report of The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees.

The amendment to SAS No. 61 requires an auditor to discuss certain information relating to the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles with the audit committees of SEC clients, and encourages a three-way discussion among the auditor, management and the audit committee. The effective date for this amendment is for audits of financial statements for periods ending on or after December 15, 2000.

The amendment to SAS No. 71 clarifies that the accountant should communicate to, or be satisfied through discussions with, the audit committee that matters described in SAS No. 61 have been communicated to the audit committee by management when they have been identified in the conduct of interim financial reporting. It also requires the accountant of a SEC client to attempt to discuss with the audit committee the matters described in SAS No. 61 prior to the filing of the Form 10-Q. The effective date for this amendment is for reviews of interim financial information for interim periods ending on or after March 15, 2000.

Early application of SAS No. 90 provisions is permitted.

In connection with the issuance of SAS No. 90, the AICPA has released Practice Alert 2000-2, *Quality of Accounting Principles Guidance for Discussions with Audit Committees*. The Practice Alert is intended to provide auditors with information that may help improve the efficiency and effectiveness of their audits, as well as provide information that will assist in the preparation for and participation in discussions with audit committees. The Practice Alert is available at www.aicpa.org/pubs/cpaltr/apr2000/supps/palert1.htm.

Other Standards Developments

EITF Deliberations

In January, the FASB's Emerging Issues Task Force (EITF) issued its decision on accounting for Internet ad barter deals. In Issue No. 99-17, the EITF decided that revenues and expenses for the trading of advertising space on Internet sites should be recognized in fair value amounts only when those values are supported by a history of receiving or paying cash or securities for such transactions. In determining what its historical practice has been, a company must consider a transaction or transactions with a different counterparty, not the one participating in the particular barter deal. Further, a company is not permitted to look back more than six months unless current market circumstances are markedly different.

Disclosures are required for the value of barter transactions in which fair value measurements are used. In addition, a measure must be provided for transactions in which fair value is not used due to insufficient information. The new rule may be applied prospectively for transactions entered into after January 20, 2000, or a cumulative catch-up adjustment can be used pursuant to APB No. 20.

In Issue No. 00-2, the EITF reached consensus on a portion of its rulemaking related to Web site development costs. The EITF decided that initial development costs for the graphics (e.g., computer-generated logos and illustrations) placed on a firm's Web site should be capitalized, while changes to the graphics should be expensed.

In Issue No. 00-7, the task force decided an accounting question focusing on equity derivative contracts indexed to, and potentially settled in, a company's own common stock and, more specifically, contracts that could require cash settlement if certain events occur. Those derivative contracts containing any provision

that could require net cash settlement cannot be accounted for as equity of the issuer or seller. The required alternative is to transfer to temporary (mezzanine) equity an amount equal to the cash redemption amount under terms of the physical settlement.

The EITF's review of this issue made the staff of the SEC aware of an apparent lack of compliance with a rule on presentation of redeemable preferred stock in the financial statements (SEC Accounting Series Release No. 268; Article 5-02.28 of Regulation S-X). This rule requires that, to the extent there are conditions (regardless of the possibility of occurrence) by which holders of equity may demand cash from the seller in exchange for instruments, the issuer must shift to temporary equity a cash amount matching the redemption amount under physical settlement.

FASB Issues ARO Proposal

In February 2000, the FASB issued a proposal, *Accounting for Obligations Associated with the Retirement of Long-Lived Assets*, which is a revision of a February 1996 exposure draft. The guidance provides a uniform approach to the treatment of expenses related to the retirement of tangible long-lived assets. The scope of the proposal includes the requirements for initial measurement of a liability for asset retirement obligations (ARO) for all industries.

The proposal requires that an ARO be recognized as a liability when incurred at acquistion or through operations, measurement of the liability at fair value, and recognition of changes in the amount of the liability due to the passage of time and timing or amount of estimated cash flows. An offsetting asset retirement cost would be recognized as an increase in the carrying amount of the related long-lived asset. The liability must be recognized when a future transfer of the asset is probable and the amount of the liability can be estimated. Examples include the requirement to dismantle an asset or cleanup contamination of a facility upon retirement.

Not included within the scope of the ARO proposal are obligations that arise solely from a plan to dispose of long-lived assets. These obligations are covered under FASB 121 and are recognized in connection with a plan of disposal.

The proposal would be effective for financial statements issued for fiscal years beginning after June 15, 2001. However, earlier adoption would be encouraged.

FASB Readies Proposal

The FASB expects to issue a proposal by the end of June on how to account for financial instruments that have characteristics of both liabilities and equity. Instruments that the proposal will cover include convertible debt and puttable common stock. The FASB's preliminary framework under the proposed guidance would require an evaluation of the existence of an obligation in distinguishing between liability and equity instruments.

NAREIT Law & Accounting Conference

Final arrangements are being made for NAREIT's 2000 Law & Accounting Conference to be held on May 17-19 at the Doral Golf Resort & Spa, Miami, Florida. The Conference is the best way for real estate executives and others to keep abreast of financial reporting, legal, and tax developments affecting the industry. Registration materials were recently distributed. If you have any questions, please contact Rebecca Vega at (202) 739-9400 or rvega@nareit.com, or you can register online at www.nareit.com.

Any questions about industry accounting and financial reporting practices should be directed to George Yungmann, Vice President, Financial Standards, at (202) 739-9438 or gyungmann@nareit.com, or David Taube, Director, Financial Standards, at (202) 739-9442 or dtaube@nareit.com.