Real Estate Accounting

Quarterly

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Editors note: Starting in the year 2000, the Real Estate Accounting Quarterly will be disseminated by email only, and will be posted on the "Members Only" section of www.nareit.com. Anyone that wishes to continue receiving the newsletter should send their email address to: email_me@nareit.com. Thank you.

From the Council

FFO Recommendations Approved by Leadership

As detailed in a November 8, 1999 National Policy Bulletin, NAREIT's Leadership determined that Funds From Operations (FFO) should include both recurring and non-recurring operating results -- except those results defined as "extraordinary items" under generally accepted accounting principles (GAAP) and gains and losses from sales of depreciable operating property. The FFO White Paper will be modified to reflect this clarification.

The Best Financial Practices Council wishes to thank all respondents who submitted comments on the proposals for modifying the industry's supplemental performance measure. The comment letters or analyst reports submitted in response to the paper, "Discussion, Potential Modifications, and Requests for Comment Concerning the REIT Industry's Supplemental Performance Benchmark," were thoughtful and provided invaluable input to the Council's deliberations. Of great importance, comments were received from all sectors of the industry and covered the spectrum of possibilities for modifying the benchmark -- from maintaining the existing definition to eliminating the use of Funds From Operations (FFO) and solely embracing net income under generally accepted accounting principles (GAAP).

In order to identify and evaluate potential implementation issues, the Council formed an Implementation Task Force. This 23-member panel, representing a cross section of NAREIT members, met twice and prepared a report of its conclusions for the Council. The Council reviewed all of the comments received, including the Task Force report, and developed its final recommendations to NAREIT's Leadership for discussion at the October 27 Executive Committee and Board of Governors meetings.

Dilutive Securities

In July 1999, at the recommendation of the Council, NAREIT distributed a National Policy Bulletin, *Guidelines for Reporting Performance on a Per Share Basis*, to NAREIT's Accounting Committee, Board Associate Members and Investors Advisory Council. The Council reiterates its recommendation that only those securities that are dilutive should be included in the calculation of diluted FFO per share. Further, when computing the incremental effect for each group or series of potential common shares, companies should not rely on the same computation used to calculate EPS based on net income. Some securities that are antidilutive for EPS might be dilutive for FFO per share, and some securities that are dilutive for EPS might be antidilutive for FFO per share. Therefore, it is necessary to make a separate calculation for each security to determine if it is dilutive or antidilutive for FFO per share. (FASB Statement No. 128, paragraphs #13 through #16)

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NAREIT Forms Cost Capitalization Task Force

In August, NAREIT formed a Cost Capitalization Task Force to provide input to an AICPA/AcSEC project as it develops an accounting standard [Statement of Position (SOP)] that would distinguish which expenditures related to operating real estate should be capitalized or expensed. NAREIT's task force held its first meeting in October and will focus on the following issues in formulating its recommendations to AcSEC:

1. capitalization vs. expense;
2. development of specific criteria for what qualifies for cost capitalization;
3. the resulting impact on depreciation expense; and
4. the resulting impact on GAAP net income, as well as FFO.

The Securities and Exchange Commission (SEC) has identified diversity in practice regarding capitalization of costs as one of the most prevalent accounting inconsistencies in the real estate industry. To ascertain whether diversity in industry practice actually exists, the task force is developing a survey to determine which costs are being capitalized and which are being expensed. Each sector of the industry will be surveyed on cost capitalization practices, as well as company policy for indirect costs and minimum dollar threshold for cost capitalization.

NAREIT's task force will provide timely input to AcSEC's Task Force and ultimately respond to AcSEC's proposed SOP, expected in the third quarter of 2000. A final standard is planned for the first quarter of 2001.

FASB Carves Out Exception for Stock Compensation to Outside Directors

In connection with its proposed interpretation of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, the Financial Accounting Standards Board (FASB) has reversed its position that would have excluded outside directors from the advantageous accounting provisions of APB 25. With this reversal, outside directors would continue to be treated as employees when accounting for stock based compensation, requiring no charge to earnings. NAREIT's Stock Compensation Task Force advocated this accounting treatment in the industry's June comment letter to the FASB.

During recent deliberations, the FASB has reaffirmed the following decisions:

- Affiliated entities - APB 25 would apply to stock-based compensation issued by a parent to a subsidiary's employees, so long as the subsidiary is accounted for on a consolidated basis. Further, it would apply for purposes of reporting in the separate financial statements of the subsidiary. APB 25 would not apply if the subsidiary is not consolidated, thus possibly requiring compensation expense.
- Repricings - Repriced stock options that were originally accounted for as a fixed award (non-compensatory) would have to be accounted as a variable award (compensatory).
- Grant date - Stock awards granted under a plan that is subject to shareholder approval will not be deemed granted until approval is obtained.
- Deferred tax assets -- The carrying amount of a deferred tax asset recognized for a temporary difference linked to a stock-based award accounted for under APB 25 should not be adjusted for a subsequent decline in stock price.

Recent discussions on whether stock-option modifications (e.g., accelerated vesting or the extension or renewal of the option term) would result in a new measurement date resulted in a FASB stalemate. However, the preference appears to be as the issue was proposed -- stock-option modifications would result in the potential recognition of compensation expense if the increase in fair value of the stock option or award resulting from the modification is more than de minimis. The FASB plans to issue a final interpretation in the first quarter of 2000.

FASB Issues Business Combinations Proposal

In September, the FASB issued its long-awaited exposure draft on business combinations and intangible assets. As anticipated, the proposed Statement would require that all business combinations be accounted for using the purchase method, thus eliminating the pooling-of-interests method. The Statement provides guidance for determining the acquiring company, primarily through an assessment of control and transaction terms.

The proposed Statement establishes new accounting for intangible assets, including goodwill. A presumption is established that the useful economic life of an intangible asset is no more than 20 years (down from a maximum of 40 years under current practice), requiring goodwill to be charged against earnings over the shorter period. Companies would be permitted to present goodwill charges (net of tax) and the subtotal before goodwill charges on a per-share basis on the face of the income statement. Goodwill amortization expense also would be displayed as a separate line item within income from continuing operations after a subtotal such as "income before goodwill charges and extraordinary items."

An exception to the 20-year useful-economic-life presumption would be provided for identifiable intangible assets with a finite useful economic life exceeding 20 years supported by identifiable cash flows. Identifiable intangible assets with an indefinite useful economic life supported by identifiable cash flows for which there is an observable market would not be amortized.

The accounting provisions of the proposal would apply to business combinations initiated after issuance of the Statement. The financial statement presentation and disclosure requirements would also apply to previously recognized intangible assets (and associated goodwill) if practicable to do so. NAREIT is forming a task force to consider preparing an industry comment letter responding to the proposal. Anyone interested in participating should contact David Taube at (202) 739-9442 or dtaube@nareit.com. The deadline for comment is December 7, 1999. The FASB plans to hold hearings on the proposal next year and issue a final standard in the latter part of 2000. The Exposure Draft is available on the web at www.fasb.org.

FASB Releases G4+1 Proposals on Joint Ventures and Reporting Financial Performance

As a member of the G4+1 group of accounting standards boards, the FASB has issued Special Reports on *Reporting Interests in Joint Ventures and Similar Arrangements* and *Reporting Financial Performance*. The G4+1 comprises 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 group is to achieve convergence of financial reporting standards so that the information is more useful to capital market participants. The Special Reports are issued to develop a common understanding of the related issues with the goal of developing international consensus.

Attempting to address wide diversity in standards and practice, the joint ventures 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.

Some real estate industry participants believe that proportionate consolidation provides significantly more useful financial statements than equity method reporting. This report provides the industry the opportunity to evaluate and potentially advocate this position.

The position paper on *Reporting Financial Performance* is designed to provide a sole approach that would potentially lead to a meaningful increase in international comparability. The report proposes a single performance statement showing all changes in equity from all sources other than transactions with shareholders. The statement would present a full analysis of financial performance with three main components: 1) results of operating or trading activities; 2) results of financing and other treasury activities; and 3) other gains and losses. In addition to related disclosure issues, the report also covers other statement items such as unusual items, income tax allocation, discontinued operations, changes in accounting policy, changes in estimates, and corrections of errors. Through its involvement in this report, the FASB hopes to obtain information to assess the effectiveness of its existing standards on reporting financial performance.

NAREIT is forming task forces to consider preparing industry comment letters responding to the G4+1 proposals. Anyone interested in participating should contact David Taube at (202) 739-9442 or dtaube@nareit.com. The deadline for comment is January 31, 2000. Both reports are available from the FASB Order Department (800-748-0659).

FASB Plans Asset Impairment and Disposal Exposure Draft

In connection with its development of guidance on Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived*

Assets to Be Disposed Of, the FASB plans to issue an exposure draft of an interpretation in the first quarter of next year. The interpretation primarily will be focused on addressing implementation issues related to assets to be disposed of, as well as the development of a uniform accounting model for assets to be disposed of and associated costs.

During recent deliberations, the FASB has tentatively decided that assets to be disposed of, as well as the liabilities associated with them, should be presented separately in the balance sheet (no offsetting permitted). Also, an asset that is to be abandoned should be accounted for as an asset held and used as long as it is being used. Depreciation of the asset would cease only when it is no longer being used and is then considered held for abandonment.

Related to its review of long-lived asset disposal, the FASB also plans to amend APB No. 30, covering segment disposals and discontinued operations, so that the provisions of FASB 121, as proposed in the interpretation, would apply to discontinued segments. The 1973 rule would be amended to use the notion of "significant component of a business" rather than "segment of a business" when referring to operations deemed to be a business segment.

Upon release of the exposure draft, NAREIT plans to form a task force to develop an industry comment letter. Anyone interested in participating should contact David Taube at (202) 739-9442 or dtaube@nariet.com.

NAREIT Submits Industry Response to IASC Investment Property Proposal

In August, NAREIT formed a task force to respond to the International Accounting Standards Committee's (IASC) proposal that would require fair value accounting for investment property. Under the proposal, investment property is defined as property that is held to earn rentals or for capital appreciation. Investment property would be carried on the balance sheet at fair value, with unrealized gains and losses from changes in fair value reported in net profit or loss. Outside appraisals to determine fair value would be encouraged but not required.

The industry's October 29 comment letter suggests that adoption of fair value accounting for investment property would alleviate, if not eliminate, the related shortcomings associated with GAAP depreciation, as well as the need for a supplemental performance measure. Based on this, the task force supported the direction of the IASC, but indicated that there are certain issues that must be more fully investigated before the industry would be a proponent of adopting fair value accounting for investment property in the US. Issues of concern include credibility related to valuing assets above cost, inclusion of unrealized gains and losses in operating results, potential costs associated with implementation, and required disclosures to appropriately adopt a true "marked-to-market" fair value accounting approach.

A major concern that the task force had was the requirement to include unrealized gains and losses from marking-to-market in net profit or loss. We suggested that these changes in value should only be reflected in equity. However, we also suggested that if the final standard requires that changes in value are included in net profit or loss, realized and unrealized gains and losses should be presented as separate line-items.

The task force's comment letter is available in the "Members only" section of www.nareit.com.

International Accounting Committee Moves Closer to Completing Core Standards - But FASB Still has Substantial Concerns

For more than a decade, the International Accounting Standards Committee (IASC) has been working closely with The International Organization of Securities Commissions (IOSCO) to develop a comprehensive set of core accounting standards that would be acceptable for cross-border capital raising and listing purposes in capital markets around the world. In 1995, the IOSCO agreed on an IASC work plan that, if completed, would meet this requirement for a comprehensive set of standards.

The SEC is an active participant in the IOSCO and has indicated that a condition for its acceptance of International Accounting Standards (IAS) is that an identified core set of standards must constitute a comprehensive generally accepted basis of accounting. The current IASC exposure draft requiring fair value accounting for investment property is the final standard that, if adopted, will complete the core set of International Accounting Standards for an assessment by the IOSCO, as well as the SEC's required comprehensive basis of accounting.

Currently, the SEC requires that foreign companies seeking to list their securities in the U.S. either file U.S. GAAP financial statements or provide a reconciliation from their home country GAAP to U.S. GAAP. Due to differences in accounting, the restatement often results in significant earnings declines. Despite the burdensome requirement and earnings impact, U.S. exchanges list more foreign companies than exchanges in any other country.

Although the SEC generally supports IAS, the SEC will require the concurrence of the Financial Accounting Standards Board (FASB) before the international standards are acceptable as U.S. GAAP. The FASB recently issued a report comparing U.S. GAAP with the proposed core set of international standards, identifying more than 200 key differences. The FASB believes that the international standards are somewhat inferior to U.S. GAAP because they provide financial statement preparers the ability to select from alternative accounting treatments for similar business transactions, lack specific requirements or guidance with respect to certain proposed standards, and do not have an enforcement mechanism.

SEC Rulemaking

Staff Accounting Bulletin on Materiality Issued

Is that last penny a share material? Last fall, SEC Chairman Arthur Levitt committed that the Commission's staff would clarify its views on the criteria for evaluating materiality. On August 12, the SEC issued Staff Accounting Bulletin No. 99 which emphasizes that qualitative as well as quantitative factors must be used in making determinations as to whether a misstatement in the financial statements is material. The Bulletin states: "materiality concerns the significance of an item to users of financial statements" and "a matter is material if there is a substantial likelihood that a reasonable person would consider it important."

The Bulletin also indicates that a quantitative rule-of-thumb approach might be used "as an initial step," but that all "facts and circumstances" must be evaluated to determine materiality.

It sets forth the types of "facts and circumstances" that may cause a misstatement of a financial statement item to be material even if it is considered immaterial on a quantitative basis. They include situations where the misstatement:

- makes a change in earnings or other trends, masks a failure to meet analysts' expectations, or changes a loss into income (or income into loss);
- arises from an item that can be measured precisely;
- affects the registrant's compliance with regulatory or contractual requirements;
- affects the reported results of a significant segment of the registrant's business;
- increases management compensation; or
- conceals an unlawful act or transaction.

A fuller discussion of this SEC policy will be included in a future "Real Estate Portfolio" article.

Audit Committees

In connection with the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, the SEC has proposed new rules for corporate audit committees designed to improve the reliability and credibility of public companies' financial statements. The proposed rules would require review of quarterly statements (10-Q and 10-QSB) by independent auditors before filing with the SEC, as well as a report from the audit committee in proxy statements that discloses whether the committee has reviewed and discussed certain matters with management and the auditors. The proposals also would require the audit committee to disclose whether it has a written charter and to file an audit committee's charter every three years.

Companies listed on the New York Stock Exchange, the American Stock Exchange, and the NASDAQ Stock Market would have to disclose information about any non-"independent" audit committee member, according to a definition of "independent" to be set by those exchanges. Companies not listed on those exchanges would have to disclose, if they have an audit committee, whether the members of the audit committee are "independent" based upon the exchanges' definition.

Consideration of "Aircraft Carrier" Release Deferred

Consideration of the SEC's proposal to make significant changes to its reporting and registration system (coined the "aircraft carrier" due to its scale) has been deferred until 2000. As originally issued, the proposal would have required companies to report the "selected financial data" required by Item 301 in Regulation S-K on Form 8-K on the earlier of either the date the company issues a press release containing earnings information or 30 days after the end of each of the first three fiscal quarters, or 60 days after the end of the fiscal year. In the alternative, the SEC proposes that issuers file quarterly reports within 30 days of the end of the first three fiscal quarters or 60 days after the end of the fiscal year.

The proposal also would expand the list of items subject to disclosure on Form 8-K, and accelerate disclosure deadlines, to include the following:

- material modifications to the rights of security holders (within 5 days);
- departure of the CFO, CEO or COO (within 1 day);
- material defaults on senior securities (within 1 day);
- some auditor notifications (within 1 day); and
- company name changes (within 5 days).

Due to significant opposition to the proposal in general, and the filing deadlines specifically, it is widely expected that the SEC will re-propose the release next year, making substantial changes that would take into account the numerous responses received. The re-issuance is anticipated to include another comment period.

Mergers and Acquisitions ("M&A") Release Update

The SEC's proposals intended to update and simplify regulations relating to mergers and acquisitions are expected to be issued with few changes. The four main goals of the proposal include: 1) expanding communications in tender offers and mergers; 2) equalizing stock and cash tender offers; 3) simplifying disclosure requirements for tender offers and mergers; and 4) modernizing the tender offer rules.

NAREIT's comments on both the "Aircraft Carrier" and "M&A" releases, as well as summaries of the releases, are available on the web in the Government Relations section of the Members only menu of www.nareit.com.

NAREIT CFO Workshop

Final arrangements are being made for NAREIT's 1999 CFO Conference to be held in Reston, Virginia on November 15 and 16. Sponsored by the Big-5 accounting firms, the program will provide an opportunity for corporate members to discuss accounting standards proposals; the real value of business process improvement; the fuss over fair value; what's capitalizable and what's not; and the latest in credit rating. Registration materials were recently mailed. If you would like to attend and did not receive a brochure, please contact Catherine Kaempffer (202) 739-9427 or ckaempffer@nareit.com.

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