NAREIT National Accounting

Update

May 3, 2002

National Association of Real Estate Investment Trusts®

Implementation of FASB Statement 144

NAREIT staff has received many inquiries regarding the implementation of the Financial Accounting Standards Board's (FASB) Statement 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. A number of these questions focus on reporting the financial results of "merchant building activities" – generally conducted in taxable REIT subsidiaries. We have held a number of conference calls with representatives of NAREIT member companies and have discussed implementation issues, including the KPMG paper referred to below, with a number of audit firms.

The attached paper, *Issues Related to Discontinued Operations Reporting Under FASB Statement No. 144 for Real Estate Entities*, was developed by KPMG. This paper sets forth many of the questions being asked by industry participants with respect to implementing Statement 144 and provides current guidance with respect to these questions. Many of the questions included in the paper were discussed with the FASB staff and, where indicated, reflect the views communicated by the staff. It is important to note that each of these FASB views involved FASB staff members as well as at least one member of the Board itself.

In discussing with KPMG representatives the questions raised in the paper and the process of developing the guidance with FASB input, it seems clear that the FASB is taking a very rigid stand that virtually all dispositions of income-producing properties should be accounted for as discontinued operations. There seems to be virtually no room to apply a significance notion or materiality test to the fundamental question of whether a property meets the definition of "component" as defined in Statement 144. The only narrow exceptions are apparently (1) when a property is being constructed under a "build-to-suit" contract and is sold immediately upon completion and (2) where there has been virtually no rental revenue reported with respect to the property sold.

If you have any questions regarding this Accounting Update, please contact George Yungmann at 202-739-9432 or gyungmann@nareit.com.

Issues Related to Discontinued Operations Reporting Under FASB Statement No. 144 for Real Estate Entities, May 3, 2002

This KPMG paper discusses examples of property dispositions common in real estate entities and addresses whether the disposition qualifies for reporting as discontinued operations under FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Each of the examples assumes that the property or entity in question has identifiable cash flows that are largely independent of other assets and, therefore, represents an asset group under Statement 144.

In developing this paper, KPMG submitted certain issues to the FASB staff and obtained the informal views of the FASB on how Statement 144 should be applied. An asterisk precedes those examples discussed with the FASB staff and the answers for those examples reflect the views communicated by the FASB staff.

Example 1(a) – Build-to-Suit Property With Contract to Sell in Place Prior to Construction

Facts – Company A constructs a build-to-suit property for a known buyer under a contract whereby upon completion of the construction the property will be sold to the buyer. The entire purchase price of the property will be funded at closing.

Q: Should the disposition of the property be reported as a discontinued operation?

A: No. The costs incurred under the contract are similar to inventory costs. Statement 144 did not amend or nullify ARB 43, Restatement and Revision of Accounting Research Bulletins. Chapter 14 in ARB 43 provides authoritative guidance on inventory impairment. FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects, provides guidance on the types of costs that are eligible for capitalization during the construction period. AICPA Statement of Position No. 81-1, Accounting for Performance of Construction/Production Contracts, provides guidance on how a contractor should account for performance under the contract. Properties constructed pursuant to contracts with unrelated parties that are accounted for under SOP 81-1 and the manufacture of goods for sale accounted for under ARB 43 are not impacted by the discontinued operations guidance in Statement 144.

* Example 1(b) – New Property Constructed and Search for a Buyer Does Not Commence Until Construction is Complete

Facts – Company B constructs a building but does not have a committed buyer for the property at the time construction is complete. At the time construction is complete, Company B begins to actively market the building and classifies the property as held for sale because it meets the other conditions in paragraph 30 of Statement 144. Accordingly, Company B never commences recognition of depreciation on the building. Company B sells the building within three months of completing the construction but prior to leasing any of the space to tenants and has no continuing involvement with the operations of the building after the sale.

Q: Should the building be reported as a discontinued operation when it is classified as held for sale?

A: No. The building does not qualify as a component of an entity under paragraph 41 of Statement 144 because the building has no associated revenues at the time it is classified as held for sale. In addition, no revenues commenced during the holding period. Therefore, the building does not have "operations," as that term is used in paragraph 41 of Statement 144. This response presumes that costs incurred and charged to the income statement during the holding period for the building are insignificant.

* Example 2(a) – New Property Constructed and Search for a Buyer Does Not Commence Until Construction is Complete and the Property is Being Leased

Facts – Company C constructs a commercial office building with the intent of selling its full *interest in the building within the first year following completion of construction. Company C believes that marketing of the building will be more effective once tenants occupy the building. Company C is successful in attracting tenants quickly and within three months has leased approximately 70 percent of the building. With that accomplished, Company C begins the search for a buyer. Three months later, Company C finds a buyer and shortly thereafter sells its entire interest in the building. Company C has no continuing involvement with the operations of the building after the sale.*

This example assumes that the paragraph 30 requirements in Statement 144 for held-for-sale classification were met just prior to the building's sale and as a result, Company B depreciated the building for a short period of time.

Q: Should the disposition of the building be reported as a discontinued operation when it is classified as held for sale?

A: Yes. Company C should report the building as a discontinued operation from the date the building is classified as held for sale because the requirements in paragraphs 41 and 42 of Statement 144 are met. The building meets the definition of "a component of an entity" as the cash flows from the property can be clearly distinguished from the rest of Company C. The operations and cash flows of the component have been eliminated and Company C will have no continuing involvement with the building's operations after the sale. Discontinued operations reporting is not required, however, if the disposition is immaterial to Company C.

Example 2(b) – New Property Constructed and the Search for a Buyer Does Not Commence Until Construction is Complete and the Property is Being Leased

Facts – Same fact pattern as Example 2(a), except that the paragraph 30 requirements in Statement 144 for held-for-sale classification are met at the time the building is ready for tenants and as a result, Company C does not depreciate the building during the period it is being leased up.

Q: Should the building be reported as a discontinued operation when it is classified as held for sale?

A: Yes. The building should be reported as a discontinued operation for the same reasons discussed in Example 2(a). The primary difference in this example is that the building is classified as held for sale at the time construction is complete, whereas in Example 2(a), the held-for-sale classification did not occur until later. While this difference does not change the reporting, it does impact the timing of when Company C begins discontinued operations reporting.

* Example 3 – Commercial Builder Purchases an Operating Property, Refurbishes it and Sells the Property at the Completion of the Refurbishment Period

Facts – Commercial Builder D buys a building that currently is leased to tenants. The building, while functional, needs a certain degree of refurbishment. Commercial Builder D intends to refurbish and then sell the building. The refurbishment takes two years to complete and, shortly thereafter, Commercial Builder D sells its entire interest in the building to an unrelated party. Commercial Builder D has no continuing involvement with the operations of the building after the sale. The tenants occupying the building when it was acquired continued to lease space in the building during the refurbishment period.

This example assumes that the paragraph 30 requirements in Statement 144 for held-for-sale classification are met just prior to the sale of the building and as a result, Commercial Builder D depreciates the building from the date of acquisition until the date the building qualifies as held for sale. Also assume that Commercial Builder D has other lines of business that are separate and distinct from the one described above.

Q: Should the building be reported as a discontinued operation when it is classified as held for sale?

A: Yes. The building should be reported as a discontinued operation from the date the building is classified as held for sale because the requirements in paragraphs 41 and 42 of Statement 144 are met. The building meets the definition of a "component of an entity," as the cash flows from the property can be clearly distinguished from the rest of Commercial Builder D. After the sale occurs, the operations and cash flows of the component have been eliminated and Commercial Builder D has no continuing involvement with the operations of the building. Discontinued operations reporting is not required, however, if the disposition is immaterial to Commercial Builder D.

* Example 4(a) – Entity Sells a Majority Interest in a Previously Controlled Real Estate Entity and Accounts for the Retained Minority Interest Under the Equity Method

Facts – Company E sells the majority of its interest in a previously controlled (consolidated) entity whose primary asset is a commercial office building. Company E accounts for the retained minority interest in the entity using the equity method.

Q: Should the building be reported as a discontinued operation?

A: No. The disposition of a majority of an interest in a previously controlled or wholly owned entity does not qualify for discontinued operations reporting if the retained minority interest provides the seller with significant influence over the transferred entity. That is, the conditions in paragraph 42 of Statement 144 are not met because Company E will continue to have cash flows from its retained interest and continues to be involved with the operations of the building through its position of significant influence.

* Example 4(b) – Entity Sells a Majority of a Previously Controlled Real Estate Entity and Accounts for the Retained Minority Interest Under the Cost Method or as a Statement 115 Security

Facts – Same fact pattern as Example 4(a), except that Company E accounts for the retained interest in the entity either under the cost method or under FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities.

Q: Should the building be reported as a discontinued operation?

A: It depends on the materiality of the expected future cash flows from the retained minority interest. If expected future cash flows are clearly significant to Company E, then the disposition should not be reported as a discontinued operation. If those cash flows clearly will be insignificant, the disposition should be reported as a discontinued operation. Judgment will be required to determine the appropriate reporting.

Example 4(c) – Sale of Property to an Equity Method Investee

Facts – Company F sells a building (either newly constructed or previously operated) to an equity method investee.

Q: Should the building be reported as a discontinued operation?

A: No. The building should not be reported as a discontinued operation for the same reasons discussed in Example 4(a).

* Example 5 – Sale of Property and Concurrent Agreement to Manage the Property for Market Compensation

Facts – Company G sells its entire interest in a building (either newly constructed or previously operated) to an unrelated party and, concurrent with the sale, enters into an agreement to manage the building for the new owners for a fee commensurate with current market conditions. The management agreement is a non-cancelable two-year contract.

Q: Should the building be reported as a discontinued operation?

A: No. Even though Company G sold its entire interest in the building, Company G has not eliminated the cash flows associated with the building from its ongoing operations and has significant continuing involvement in the building's operations subsequent to the sale through the management agreement. Accordingly, the building should not be reported as a discontinued operation because the conditions in paragraph 42 are not met.

Discontinued operations reporting would be appropriate if the management agreement was only for a short period of time (such as 30 days) and the continuing involvement was eliminated within 12 months from the date that the building was classified by Company G as held for sale. In that case, Company G would report the building as a discontinued operation when the management agreement terminated. Under such a scenario, all the facts and circumstances would need to be analyzed to determine the appropriate reporting.

* Example 6 – Investor Income Statement Presentation When an Equity Method Investee Has Discontinued Operations

Facts – Company H has an investment in another entity that it accounts for under the equity method. The investee reports discontinued operations in its separate financial statements.

Q: How should Company H report in its income statement Company H's share of the investee's discontinued operations?

A: KPMG believes that an investor's income statement reporting of an equity method investee's discontinued operations should be a policy decision. Paragraph 19 of APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, does not address this question. Accordingly, depending on the policy established by Company H, the presentation either could be through the proportionate share (i.e., equity pick-up) line or as discontinued operations.

Preliminarily, the FASB staff has indicated that an investor should not report discontinued operations in its income statement for its share of the discontinued operations of an equity method investee. That is, the investor would report its share of the investee's discontinued operations in the income statement line used for its share of the investee's earnings or losses. However, the FASB staff intends to consider the issue further before finalizing its position.

Example 7 – Income Statement Presentation for a Consolidated Subsidiary with a Minority Interest When the Parent Subsequently Sells its Interest and Reports the Subsidiary as a Discontinued Operation

Facts – Company J owns a majority of an entity, which it controls and consolidates. Company J presents the minority shareholders' portion of the subsidiary's earnings as a minority interest charge in its consolidated income statement. Company J subsequently disposes of its interest in the entity and the disposal is reported as a discontinued operation.

Q: How should Company J report the minority shareholders' portion of the subsidiary's earnings when the subsidiary is reported as a discontinued operation?

A: The minority interest charge for the income statement periods presented should be included as part of discontinued operations. The minority interest charge is a component of Company J's income from the subsidiary's operations and should be classified as discontinued along with the consolidated revenues and expenses of the majority-owned entity that were previously also a component of income from operations.