NAREIT Financial Standards Update

National Association of Real Estate Investment Trusts®
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Financial Standards Update

Highlights

FASB and IASB Reaffirm Commitment to Enhance Consistency, Comparability and Efficiency in Global Capital Markets

On Feb. 27, the Financial Accounting Standards Board (FASB or Board) and the International Accounting Standards Board (IASB) published a Memorandum of Understanding (Memorandum) that reaffirms the two Boards' shared objective of developing high-quality, common accounting standards for use in the world's capital markets. Both Boards believe that a common set of high-quality accounting standards will enhance the consistency, comparability and efficiency of financial statements, enabling global markets to move with less friction.

The Memorandum is a further elaboration of the objectives and principles first described in the Boards' Norwalk Agreement published in October 2002. While the document does not represent a change in the Boards' convergence work program, it does, however, reflect the context of the 'roadmap' for the removal of the reconciliation requirement for non-US companies that use International Financial Reporting Standards (IFRSs) and are registered in the U.S. It also reflects the work undertaken by the Committee of European Securities Regulators (CESR) to identify areas for improvement of accounting standards.

Of special interest to our industry is the fact that the FASB considers the accounting for investment property to be a short-term agenda item and it is to be considered in Phase 2 of the Fair Value Option project. Phase 2 will be developed during the second half of 2006 and an exposure draft is expected in 2007. (Additional details on this proposal are in the next article.) In addition, the Memorandum states that the Boards will likely take on a major project focused on lease accounting in 2008. Click HERE for the full text of the Memorandum.

NAREIT Comments on FASB's Proposal on the Fair Value Option

On April 10, NAREIT submitted comments on Phase 1 of the FASB exposure draft titled, *The Fair Value Option for Financial Assets and Financial Liabilities* (ED). The ED, which was issued on Jan. 25, 2006, provides companies

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with the option to report selected financial assets and liabilities at fair value. Phase 2 of the project will address creating a fair value option for selected non-financial items. As indicated above, the FASB has announced that it will consider the accounting for investment property in Phase 2 of this project. In its comment letter, NAREIT acknowledged the Board's commitment to examine the accounting for investment property in the context of the Fair Value Option project, and indicated that NAREIT is looking forward to working constructively with the Board as it considers how to harmonize reporting of investment property between U.S. GAAP and IFRS.

As proposed, the fair value option standard would generally provide companies the option to report financial instruments and certain non-financial items at cost or fair value. The ED seeks to reduce both complexity in accounting and volatility in earnings caused by differences in the existing accounting rules and, in particular, the mixed attribute model. Under this current model, assets and related liabilities might be measured on different bases – cost or fair value. To decrease volatility caused by this mixed attribute accounting, under the fair value option, any unrealized changes in fair value would be included in earnings.

If applied to investment property and the fair value option were selected, this standard would eliminate investment property depreciation expense and changes in unrealized value would be included in net income. This project will most likely accelerate the FASB's evaluation of the convergence of U.S. standards with International

International Accounting Standards Board®

Accounting Standard No. 40, *Investment Property* (IAS 40). In fact, during the discussion of the Fair Value Option project, two FASB members analogized elements of the project with elements of IAS 40.

Click HERE for the Phase I exposure draft. A final Phase1standard is scheduled to be issued in the third quarter of 2006.

Click HERE to access NAREIT's comment letter.

FASB Issues Standard on Servicing of Financial Assets

On March 17, the FASB issued Statement of Financial Accounting Standards No. 156, *Accounting for Servicing of Financial Assets* (FAS 156 or Standard). The Standard, which is an amendment to FAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, will simplify the accounting for servicing assets and liabilities, such as those common with mortgage securitization activities.

Specifically, the new Standard addresses the recognition and measurement of separately recognized servicing assets and liabilities and provides an approach to simplify efforts to obtain hedge-like (offset) accounting.

The Standard also:

1. Clarifies when an obligation to service financial assets should be separately recognized as a servicing asset or a servicing liability.

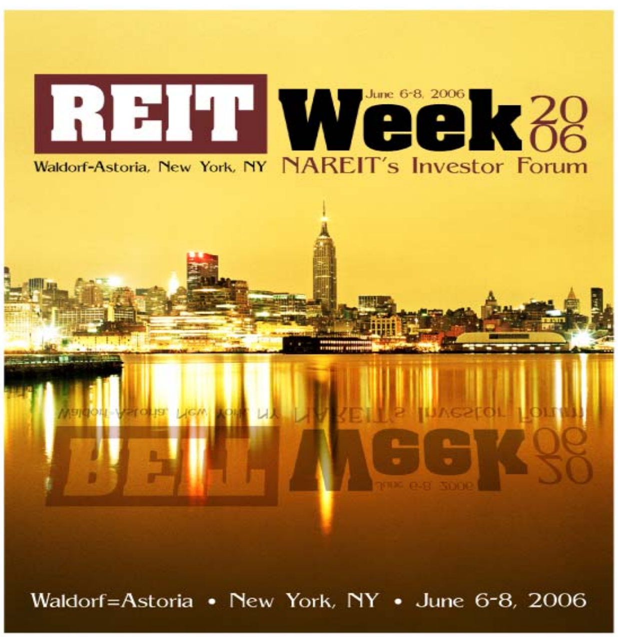
2. Requires that a separately recognized servicing asset or servicing liability be initially measured at fair value, if practicable.

3. Permits an entity with a separately recognized servicing asset or servicing liability to choose either of the following methods for subsequent measurement:
    a. Amortization Method
    b. Fair Value Method

FAS 156 permits a servicer that uses derivative financial instruments to offset risks on servicing to report both the derivative financial instrument and related servicing asset or liability by using a consistent measurement attribute – fair value. Click HERE to access the full text.

FASB Releases Exposure Draft on Defined Benefit Pension and Postretirement Plans

On March 31, the FASB released for comment an exposure draft of a proposed standard entitled *Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans* (ED). If passed, the guidance in the ED will require an employer to do the following with respect to its defined benefit pension and other postretirement plans:



- Recognize in its statement of financial position the overfunded or underfunded status of its defined benefit plans

- Recognize as a component of other comprehensive income, net of tax, the actuarial gains and losses and the prior service costs and credits that arise during the period

- Recognize as an adjustment to the opening balance of retained earnings, net of tax, any transition asset or obligation remaining from the initial application of FASB Statement No. 87, *Employers' Accounting for Pensions*, or FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*

- Measure the assets and obligations of a defined benefit plan as of the date of the employer's statement of financial position

- Disclose in the notes to the financial statements additional information about certain effects on net periodic benefit cost in the upcoming fiscal year that arise from delayed recognition of actuarial gains and losses, and prior service costs and credits

The proposal, which is the first step in the FASB's project to broadly reconsider the pension accounting model, is aimed at providing more transparency around companies' obligations to their current and future retirees. Comments are due to the FASB by May 31. Click HERE to access the ED. Please contact Gaurav Agarwal if you feel that this ED may have a significant impact on your financial reporting and if you would like to participate in developing a NAREIT comment letter.

FASB Issues Guidance on Variable Interest Entity Treatment

On April 13, the FASB issued an FASB Staff Position (FSP) addressing how a reporting enterprise should determine the variability to be considered in applying FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FIN 46(R)). The variability that is considered in applying FIN 46(R) affects the determination of (a) whether the entity is a variable interest entity (VIE), (b) which interests are variable interests in the entity, and (c) which party, if any, is the primary beneficiary of the VIE. That variability will affect any calculation of expected losses and expected residual returns, if such a calculation is necessary. The FSP can either be applied prospectively or retrospectively at the issuer's election.

The effective date for prospective application of the FSP is the first day of the first reporting period beginning after June 15, 2006, while the effective date for retrospective application is no later than the end of the annual reporting period ending after July 1, 2006 (i.e., as of Dec. 31, 2006 for a calendar year-end company). Click HERE to access the FSP.

SEC & PCAOB Announce Plans for Second SARBOX Roundtable

On May 10, the Securities and Exchange Commission (SEC or Commission) and the Public Company Accounting Oversight Board (PCAOB) will sponsor a roundtable to discuss second-year experiences with the reporting and auditing requirements of the Sarbanes-Oxley Act of 2002 related to companies' internal control over financial reporting. The roundtable will be held at the Commission's headquarters in Washington, D.C. Participants will include issuers, auditors, investors and other interested parties. NAREIT and a number of its member companies had submitted comments to the first roundtable held last year. NAREIT staff will attend the second roundtable and report any significant discussion items.

In addition to the roundtable, the SEC and the PCAOB are seeking written feedback from registrants, auditors, investors and others on their experiences with complying with the Section 404 requirements. The Commission is not soliciting feedback on a particular set of inquiries. The information that is submitted to either organization will become part of the public record of the Section 404 roundtable. The submissions are due before May 1. Please contact Gaurav Agarwal if you would like to discuss a potential NAREIT comment letter to this 2006 roundtable. Click HERE for further details about the roundtable.

Big Four Release Report on SARBOX Section 404 Costs

On April 18, the four largest accounting firms (Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers) released a report on Section 404 of the Sarbanes Oxley Act of 2002. This report was compiled by CRA International, an economic and business consulting firm, at the request of the four firms. It was designed as part of their continuing efforts to work with the PCAOB and the SEC to enhance the implementation of Section 404 and to provide relevant information for the May 10 roundtable on Section 404 implementation.

The data, which updates information provided in two earlier surveys, confirms an expectation of substantial declines in costs for the surveyed companies in the second year of implementation. While each company's actual experience will vary with its own unique circumstances, the data clearly confirms the belief that the elimination of one-time start up costs, combined with learning curve effects and additional regulatory guidance during 2005, has resulted in a general decline in costs for both smaller and larger companies that are accelerated filers.

The key findings of the CRA report include:

- Total 404 costs (including internal costs, third party costs and fees for the 404 internal control audit) declined significantly, falling 30.7 percent for smaller companies and 43.9 percent for larger companies.
- Of the total 404 costs in year two, the 404 audit fees declined an average of 20.6 percent for smaller companies and 22.3 percent for larger companies.
- Year-two 404 audit fees accounted for 39 percent of total 404 costs for smaller companies and 33 percent for larger companies.

Click HERE to access the full report.

IASB Proposes Improvements to Financial Statement Presentation

On March 16, the IASB issued proposed revisions to International Accounting Standard No. 1, *Presentation of Financial Statements* (IAS 1). These revisions are part of the IASB's Performance Reporting project (subsequently renamed Financial Statement Presentation) and, if adopted, will largely converge IAS 1 with FASB Statement No. 130, *Reporting Comprehensive Income.* The exposure draft specifies that entities should present all income and expenses in one or two statements, separately from changes in equity arising from transactions with owners in their capacity as owners. The exposure draft would also officially replace the term "balance sheet" with "statement of financial position" to more accurately reflect its purpose. Finally, entities presenting comparative, prior-period information would be required to include, as a minimum, three statements of financial position and two of each of the other financial statements. Comments are due to the IASB by July 17.

Although this proposal does not materially impact U.S. GAAP, NAREIT is considering whether to submit comments at this stage. NAREIT will continue to monitor the joint FASB/IASB Financial Statement Presentation project and provide input when deemed appropriate. Click HERE for the full release.

One Thousand Industry Participants Attend the 2006 Law & Accounting Conference

NAREIT's 2006 Law & Accounting Conference was held from March 29 through March 31 in La Quinta, CA at the La Quinta Resort and Club. NAREIT thanks Sandy Blum of PwC, Jim Fleming of Cousins Properties, Alex Rubin of UBS and Charlie Temkin of Deloitte for serving as program directors. The conference was very successful and attended by 1,000 REIT executives, outside accountants, lawyers and other professionals servicing our members.

The program provided a broad range of learning experiences. Sessions covered recently issued and proposed accounting, securities law and tax standards, the new corporate governance and financial reporting environment, the current capital markets and best practices with respect to financial reporting. Based on the evaluations received to date, 86% of the attendees felt that the conference met or exceeded their expectations.

In addition, for the first time, this year's L&A Conference featured a series of roundtables. The purpose of these roundtables was to give attendees an opportunity to share ideas, raise concerns, discuss issues in-depth and also network.

At the Accounting Committee meeting, Rob Fleshman of Deloitte presented his firm's views on the proposed guidance on asset retirement obligations, while Hans Gronloh of KPMG, Netherlands, discussed the implementation issues faced by companies in Europe who reported under the International Financial Reporting Standards for the first time at 2005 year end.

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