September 2008

# NAREIT Financial Standards Update

National Association of Real Estate Investment Trusts®
*REITs: Building Dividends and Diversification®*

Financial Standards Update

## Highlights



## FASB and IASB Issue Update to MOU

On Sept. 11, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) published an update to the Memorandum of Understanding (MOU) that was released in 2006, *A Roadmap for Convergence between IFRS and U.S. GAAP – 2006-2008*. The update discusses the FASB and IASB's progress since 2006 and sets forth a plan toward the development of a common set of high quality standards by completing the open 2006 MOU projects by 2011.

The updated MOU addresses the status and timelines for both the short-term convergence projects and major joint projects. Under the ongoing short-term convergence projects, the FASB will determine whether to take on a number of projects that would eliminate significant differences between U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). One of these projects focuses on accounting for investment property, in which the FASB may consider adopting International Accounting Standard (IAS) 40 *Investment Property*. Given the potential adoption of IFRS in the U.S., as discussed below, the FASB will review its strategy on such short-term convergence projects during the remainder of 2008.

In connection with the FASB's *Fair Value Option – Phase 2, Investment Property Project*, NAREIT presented its current position on investment property to the FASB and the Securities and Exchange Commission (SEC) earlier this year. Overall, NAREIT acknowledges the global movement toward reporting investment property at fair value under IAS 40, but would like to see certain modifications to IAS 40 if adopted in the U.S.

The *Financial Statement Presentation*, *Leases* and *Revenue Recognition Projects* are some of the major joint projects projected to be completed in 2011 with the issuance of Preliminary Views Documents (PVD) expected before the end of 2008. These projects are subject to the Boards' due process; therefore, the completion dates may vary based on the input received throughout a projects'



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development. Click here to review the update to the MOU.

The completion of these major projects moves the Boards closer to achieving high quality, global financial reporting standards. The Boards recognize that the progress toward convergence could affect the SEC's decisions on the adoption of IFRS in the U.S.

### SEC Proposes Roadmap to Adopt IFRS in 2014

On Aug. 27, the SEC approved the release of a proposed roadmap that would, if certain milestones are reached, result in all U.S. issuers preparing their financial statements under IFRS beginning in 2014.

### Major Potential Impacts of IFRS Adoption on Real Estate Financial Reporting

The following areas represent certain major potential impacts of adopting IFRS on our member companies' financial reporting:

*Investment Property.* IFRS provides an option to report investment property at fair value or historical cost with disclosure of fair value in the footnotes. The unrealized gains or losses from reporting investment property at fair value would be recognized in earnings. In conjunction with the FASB/IASB *Financial Statement Presentation Project*, NAREIT and its Real Estate Equity Securitization Alliance (REESA) global partners have developed a global real estate financial statement model that would report unrealized fair value gains or losses outside of industry metrics.

*Property and Equipment.* In accordance with IAS 16 *Property, Plant and Equipment*, an entity can elect to report property and equipment using the cost or the revaluation model. The revaluation model allows companies to remeasure property and equipment at fair value and record the change in value directly to equity. However, depreciation under the revaluation model is recorded based on the revalued amount, which results in a higher depreciable basis and an increase in depreciation expense. Another significant difference between U.S. GAAP and IFRS in accounting for property and equipment is the requirement under IAS 16 to componentize significant parts of these assets that have different estimated useful lives. For instance, depreciation of a building is based on the individual estimated lives for each component (i.e., building shell, heating system and roof, etc.), as opposed to the weighted average of the building components' lives used under U.S. GAAP.

*Impairment.* Under IFRS, the impairment of an asset is determined by comparing the carrying value of an asset to its recoverable amount. If the carrying value is higher, the asset is written down to its recoverable amount and an impairment loss is recognized. The recoverable amount is defined as the greater of the asset's value in use, which is based on discounted future cash flows, and the fair value less selling costs. U.S. GAAP requires an impairment loss to be recognized after applying a two-step process. First, the asset's carrying value is compared with the amount of undiscounted future cash flows generated by the asset and, second, if the carrying value is higher, then the asset is written down to fair value.

As a result, the frequency of impairment losses under IFRS is expected to increase, and impairment losses are expected to be recognized earlier compared to U.S. GAAP.

*Sales of Real Estate.* Similar to U.S. GAAP, IFRS considers the transfer of risks and rewards in

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determining when sales of real estate, as well as any other asset, should be recognized. In contrast to U.S. GAAP, IFRS does not provide specific rules on the accounting for sales of real estate and does not provide "bright lines," *i.e.,* downpayment requirements, for recognizing sales of any asset.

*Leases.* Similar to the IFRS guidance on sales of real estate, IFRS does not give detailed criteria for lease classification that are required under U.S. GAAP. This lack of detailed guidance is consistent with the IASB's principles-based approach to accounting standards as compared to U.S. GAAP's rules-based approach.

Additionally, as discussed above, the FASB and IASB are working on a number of convergence projects that may change the current impact on real estate financial reporting.

## Highlights of the SEC Proposal

The proposed multi-year roadmap sets out several milestones that, if achieved, could lead to the adoption of IFRS by U.S. issuers. In addition to continual improvements to IFRS and the attainment of independent funding for the International Accounting Standards Committee Foundation (the governing body of the IASB), these milestones consider the ability to use eXtensible Business Reporting Language (XBRL) in filings under IFRS, education and training of IFRS in the U.S. and the experiences by early IFRS adopters in the U.S.

Key dates in the roadmap would include:

*2009:* Voluntary IFRS adoption permitted for a limited group of U.S. issuers. This limited group would represent the largest 20 U.S. companies based on market capitalization within their worldwide industries that already predominantly use IFRS. The SEC expects approximately 110 U.S. companies in about 34 industries to be eligible for voluntary IFRS filings, which will help determine the cost-benefits of and market reaction to the adoption of IFRS in the U.S. Initial feedback suggests that there may potentially be several large public U.S. REITs that would be eligible for early adoption of IFRS. NAREIT staff will inquire as to whether any of these companies would like to apply to the SEC for early adoption.

*2011:* SEC to finalize its decision of whether or not to mandate IFRS adoption.

*2014:* Proposed start date for mandatory IFRS adoption to be implemented on a multi-year plan for U.S. issuers.

The proposal will be open for a 60-day comment period after its publication in the *Federal Register*. If you are interested in joining a task force to assist in the preparation of NAREIT's comment letter on this SEC proposal, please contact Sally Glenn at sglenn@nareit.com.

## NAREIT Submits Comments on SEC Proposal that Would Restrict UPREIT Debt Issuances

On Sept. 5, NAREIT submitted comments to the SEC on its proposed rule that would create serious roadblocks to UPREITs' continued efficient access to public debt capital markets through their operating partnerships (OPs) using the Form S-3 shelf registration process. The proposed rule would require that companies have issued more than $1 billion in non-convertible debt securities for cash over the past three years in order to use this efficient access to debt markets. To access the proposed rule, click here.

Currently, SEC rules allow companies to register non-convertible debt securities with investment grade ratings using Form S-3 – a streamlined issuance process. The Form S-3 shelf registration process permits eligible issuers to register securities offerings in advance of any specific offering and, once the registration statement is effective, offer securities rapidly in one or more tranches without waiting for further SEC action. However, in July the SEC released a series of proposed rules to steer away from regulatory reliance on security ratings as a result of current credit market conditions.

In its comment letter, NAREIT indicated that the vast majority of SEC-registered REITs with an UPREIT structure would effectively be precluded from accessing public debt capital in an efficient manner through use by their OPs of the shelf registration process. The letter suggested that this limitation on REITs' access to debt capital markets could, in turn, result in a variety of other undesirable effects on financial and real estate market activities at a time when these effects are likely to be particularly harmful, given the current reduced availability of credit.

NAREIT proposed the following eligibility requirements for use of Form S-3 by debt-only issuers: 1) the application of the principal amount of debt securities ***outstanding***, rather than the principal amount *issued during a three year period*; 2) the application of a dollar threshold (outstanding principal amount), such as ***$300-$500 million***, that is lower than that required to qualify as a "well known seasoned issuer;" 3) the inclusion in the test of *all* debt securities issued in both registered and exempt offerings, rather than only those issued in *registered public offerings* during a three year period; and, 4) the inclusion in the test of *all* debt securities outstanding (whether or not convertible or exchangeable), rather than only *non-convertible* debt securities outstanding. To access NAREIT's comment letter, click here.

## FASB Releases Earnings Per Share Exposure Draft

In August, the FASB issued an Exposure Draft, *Earnings Per Share – an Amendment of FASB Statement No. 128* ("the ED") that is intended to simplify the calculation and move closer to converging with the IFRS EPS calculation. The proposed changes under the ED, along with the proposed IASB amendments to IAS 33 *Earnings Per Share,* would result in the same denominator, with limited exceptions. The proposed changes to U.S. GAAP would also modify the computation of both basic and diluted EPS. To access the ED, click here.

### Basic EPS

According to the ED, basic EPS would include all common shares outstanding and instruments that provide the holder with present rights, as of the end of the period, to share in current-period earnings with common shareholders. These instruments include instruments that are currently exercisable or shares that are currently issuable for little or no cost to the holder, participating securities that are not measured at fair value through current-period earnings (*e.g.*, a share-based payment award that is recognized as equity) and classes of common stock with different dividend rates from other classes of common stock but without prior or senior rights. The method in which these instruments are included in basic EPS would depend on the nature of the instrument. For instance, shares that are currently issuable for little or no cost to the holder would be included in the denominator as if they were outstanding common shares and participating securities, in certain cases, would be included through a numerator adjustment using the current "two-class method."

### Diluted EPS

The ED primarily affects diluted EPS in the application of: 1) the treasury stock and reverse treasury stock methods; 2) instruments that may be settled in cash or shares; and, 3) instruments measured at fair value through earnings.

*Treasury Stock and Reverse Treasury Stock Methods.* In applying the treasury stock and reverse treasury stock methods under the ED, an entity would use the end-of-period market price of common shares, as opposed to a weighted average share price for the period, to determine the incremental number of shares to be included in the denominator. This change to the treasury stock and reverse treasury stock methods may potentially increase volatility in diluted EPS and diluted Funds From Operations (FFO) per share due to the application of an entity's share price at a certain point in time rather than a weighted average share price. Furthermore, this change may make it difficult to forecast diluted EPS, as well as diluted FFO per share for the period.

*Instruments that May be Settled in Cash or Shares.* Under the ED, companies with instruments that can be settled in cash or shares (*e.g.* convertible debt) would assume such instruments would be settled in shares. These shares would be included in the denominator of diluted EPS using the if-converted method regardless of a company's past practice or stated policy of settling an instrument in cash (other than legal bankruptcy of the issuer). As a result, the inclusion of these shares in the EPS denominator would decrease diluted EPS and diluted FFO per share compared to current practice.

*Instruments Measured at Fair Value through Earnings.* Based on the ED, the shares of certain instruments that are measured at fair value through current period earnings would no longer be included in diluted EPS, since the numerator already reflects the effect of the instrument through the changes in fair value recognized in earnings. For example, a company would not include in diluted EPS the shares of a share-based payment award that is recognized as a liability and measured at fair value through current period earnings.

The ED discusses in further detail the treasury stock and reverse treasury stock methods, participating securities and the application of the two-class method, as well as the independence of current period EPS calculations from prior periods (refer to the ED here).

The FASB will determine the effective date when it approves the final amendments to the ED. The ED proposes retrospective application to prior periods and prohibits early adoption. NAREIT invites you to join a task force to develop a comment letter that would provide the industry's views of the proposed amendments. To join the task force, please contact Sally Glenn at sglenn@nareit.com.

## NAREIT Objects to FASB's Proposed Disclosures about Loss Contingencies

On June 5, the FASB issued a proposal, *Disclosure of Certain Loss Contingencies – an Amendment of FASB Statements No. 5 and 141R*, that would significantly expand disclosures with respect to loss contingencies that are within the scope of FASB Statement 5 or are recognized in accordance with Statement 141R at the acquisition date in a business combination (with certain scope exceptions). The proposal was issued in response to concerns on the part of financial statement users that current disclosures regarding loss contingencies are not transparent and timely enough to provide a basis for projecting potential cash outflows. The exposure draft is available by clicking here.

On Aug. 8, NAREIT submitted its comment letter on this FASB proposal. NAREIT shared its overarching concern that the proposed accounting guidance would go far beyond those that are required to project future cash outflows from the possible realization of losses. Consistent with many of the other 235 comment letters received by the FASB, NAREIT further argued that the proposed disclosures would place a defendant company at a significant disadvantage in the adversarial relationship with a plaintiff. Click here to access NAREIT's comment letter.

On Sept. 24, the FASB announced its intentions to delay the issuance of any new standard related to this proposal until sometime in 2009.

## NAREIT Opposes FASB's Proposed Amendment to Hedge Accounting

In June, the FASB issued an Exposure Draft, *Accounting for Hedging Activities – an Amendment of FASB Statement No. 133*, to simplify and improve the accounting and financial reporting for hedging activities, resolve major practice issues that have arisen under FAS 133 and address differences in recognition and measurement between the accounting for derivative instruments and the accounting for hedged items. To view the exposure draft, click here.

Based on input from a member task force, NAREIT submitted a comment letter on this FASB proposal. While the letter indicated that NAREIT supports certain proposed amendments, NAREIT expressed its strong opposition to the elimination of the "bifurcation-by-risk model." NAREIT believes that the proposed accounting could have a significant negative impact on earnings and FFO. NAREIT's comment letter is available by clicking here.

## SEC Announces Plans to Replace EDGAR with IDEA

On Aug. 19, the SEC announced that the global system, Interactive Data Electronic Applications (IDEA), would eventually become EDGAR's successor. As the new global system will store the same information about public companies and


SEC Chairman Christopher Cox Annoucing IDEA as Successor to EDGAR Database

mutual funds as EDGAR, the SEC believes that IDEA will allow investors and other users of financial statements to access information more efficiently and accurately using the technology of XBRL. Additionally, all of the information stored in IDEA will be provided on the internet.

The voluntary XBRL filings of companies are expected to be available for investors through IDEA by the end of this year and the complete implementation of IDEA would likely take three years. During the transition to IDEA, the EDGAR database will continue to be available as an archive of company filings for past years. For more information on IDEA, click here.

## 2008 NAREIT Financial Standards Events

### Senior Financial Officers/Investor Relations Officers Workshop

NAREIT's 2008 Senior Financial Officers/Investor Relations Officers Workshop was held on Sept. 22 and 23 in New York City. Approximately 130 members attended the workshop, which provided information on the latest developments and trends impacting the financial management of real estate companies. NAREIT thanks the program directors, sponsors, and presenters for their contributions to the success of this event.

## Internal Audit Forum

NAREIT extends its gratitude to the hosts of the 2008 Internal Audit Forum held on Aug. 5 and 6 in Philadelphia, Pennsylvania: Brandywine Realty Trust, Liberty Property Trust and Pennsylvania Real Estate Investment Trust. Approximately 40 financial executives who direct member company internal audit functions attended the Forum. Feedback thus far indicates that this event continues to be very useful to attendees. We look forward to additional participant feedback in order to continue to enhance the effectiveness of this annual NAREIT event. If your company is interested in hosting this Forum in 2009, please contact Sally Glenn at sglenn@nareit.com or 202-739-9442.

## Retail Sector Operations Accounting Forum

Over 65 NAREIT members attended this Forum, which was hosted by Taubman Centers, Inc. and Ramco-Gershenson Properties Trust. NAREIT appreciates these companies sponsoring the 2008 Retail Sector Operations Accounting Forum, which was held on Aug. 13 and 14 in Detroit, Michigan. We have received positive feedback thus far that this Forum, year after year, proves to be informative to attendees. We look forward to additional participant feedback to improve the program and to maintain the continued success of this annual NAREIT event. If your company is interested in hosting this Forum in 2009, please contact Sally Glenn at sglenn@nareit.com or 202-739-9442.

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