

2006 financial services audit committee forum*

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*connectedthinking

PRICEWATERHOUSECOOPERS 

Welcome

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Agenda

- Technical update
- Audit committee best practices for real estate companies

Technical Update

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Agenda

FASB

Enacted Pronouncements:

- FAS 123(R)
- FIN 48, Accounting for Uncertain Tax Positions
- FAS 158 – Pension Accounting

Exposure Drafts and Technical Projects

- Business Combinations
- Fair Value Option
- Lease accounting project
- Miscellaneous

SEC/PCAOB

SEC – What's on the Horizon

Enacted Pronouncements

- Executive Compensation and Related Party Disclosure
- SAB 108, SEC issues guidance on Quantifying Financial Statement Misstatements

SEC Comment Letter trends

404 Year 2 Results

404 Next Steps

FAS 123(R)

Technical Guidance:

- Issued in December 2004 and effective for calendar year companies January 1, 2006
- Numerous Staff Interpretations, FAQ's, FSPs, etc.
- PwC has White Papers/Monographs on topic

FAS 123(R) (continued)

Points to Consider:

- Keep in perspective
- Generally not material for real estate companies
- Understand process and controls surrounding grants of awards
- Understand nature of specialists utilized
- Understand key assumptions for valuation of stock compensation
- Be attentive to increased disclosures (including quarterly in initial year of adoption)
- When involved with changes to equity plans, consult with financial advisors, auditors, and legal counsel

FIN 48, Accounting for Uncertain Tax Positions

Technical Guidance:

FIN 48: Prescribes a comprehensive model for how a company should recognize, measure, present and disclose uncertain tax positions that the company has taken or expects to take on a tax return

- Creates an accounting standard for area which there historically hasn't been one
- Introduces granularity and analysis for items which weren't reviewed regularly by management but perhaps should have been
- Areas of focus for REITs will be REIT tests, TRS and state issues (with latter two being more prominent)

FIN 48, Accounting for Uncertain Tax Positions (continued)

Technical Guidance:

- Recognition: A tax benefit from an uncertain tax position may be recognized only if it is more likely than not that the position is sustainable, based on its technical merits.
- FIN 48 uses a measurement methodology that is based on “cumulative probability”, resulting in the recognition of the largest amount of the tax benefit that is greater than 50% likely of being realized
- Effective for fiscal years beginning after December 15, 2006

FIN 48, Accounting for Uncertain Tax Positions (continued)

Points to Consider:

- Should not be as material an impact for REITs as it for normal tax paying entities (i.e. C-Corps)
- Assessment of all material positions existing as of date of adoption
- Understanding prior policies and implementation of the requirements of the new standard (tax benefits will be recognized when sustainability has reached the more likely than not threshold; therefore Companies will recognize tax benefits before final resolution)
- Consider effects that FIN 48 may have on financial covenants and incentive compensation plans
- Re-assessment as of each balance sheet date factors underlying the sustainability of the position and whether the amount of recognized tax benefit is still appropriate
- Greater effort in the documentation of the in-depth analysis of the UTP (dependent upon the level of judgment)

FASB Pension Accounting Project

Technical Guidance:

FASB has a two-phased project to reconsider pension/OPEB accounting

- FAS 158 issued in September 2006 (Phase I)
- Companies must recognize a net liability or asset to report the funded status of their defined benefit pension and other postretirement benefit plans on their balance sheets.
- Calendar year-end companies with publicly traded equity securities are required to adopt the recognition and disclosure provisions of FAS 158 as of December 31, 2006

FASB Pension Accounting Project (continued)

Phase I implications*:

- For pension plans:
 - Shareholders' equity for the S&P 500 would drop by \$255 billion, or 7%
 - Eighteen most underfunded plans in S&P 500 would have 25% drop in shareholders' equity
 - Seven most underfunded plans in S&P 500 would have shareholders' equity wiped out

*Based on articles that discuss a recent study by Credit Suisse.

FASB Pension Accounting Project (continued)

Even if your company doesn't have
an affected plan...

This project will impact you

Estimates indicate that as much as \$1/2 TRILLION of unrecorded liabilities will find their way onto the books

- Potential impact on stock market
- Other companies' debt covenants

Business Combinations Standard

Technical Guidance:

- Generally record acquisitions of a business at fair value with limited exceptions;
- Measurement date changed to acquisition date (from announcement date)
- Acquisition costs expensed
- Contingent assets, liabilities, earns-outs, other contingent consideration recorded at fair value on acquisition date and adjusted through earnings

Business Combinations Standard (continued)

Technical Guidance:

- Minority interest recorded as equity component
- Enhanced disclosures to include :
 - transaction costs
 - amounts from changes during measurement periods
 - gains or losses recognized
 - maximum future potential consideration
 - reconciliation of transactions with NCI

Business Combinations Standard (continued)

Points to Consider:

- Change in measurement dates could change significantly (up or down) the acquisition price from agreement date reflecting events other than the transaction
- Expensing of acquisition costs are dilutive to FFO

Fair Value Option

Technical Guidance:

FASB two phase project - Fair Value Option

Phase 1 - Certain Financial Assets and Liabilities

Irrevocable election of fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities, with changes in fair value recognized in earnings as those changes occur including investments accounted for under the equity method

- Exposure Draft Issued January 06, Comment Period ended April 06
- Anticipated issuance and effective date

Fair Value Option (continued)

Technical Guidance:

Phase 2 - Non Financial Assets and Liabilities

- Could include Investment Real Estate
- Potential timing for Phase 2
- Reasons for this Project
 - Enable entities to achieve offset accounting effect for the changes in the fair value of assets and liabilities without applying complex hedge accounting provisions
 - Convergence with International Accounting Standards
 - Pending issuance of AICPA Investment Company Guide clarifies the acceptability of when fair value is GAAP for the institutional real estate investment arena

Fair Value Option (continued)

Points to Consider:

- Historical Cost Model is not considered meaningful for Real Estate
- Given rise to reliance on Non GAAP Measures (FFO, AFFO)
- Investment community FFO quarter to quarter focus potentially at odds with shift of many REITs to value creation through development and use of ventures/investment management model, unpredictability, treatment of promotes, redevelopment gains
- Project gives opportunity for fair value measurement of equity method investments in Phase 1, potentially real estate investments in Phase 2
- Method for income statement recognition is unclear
- Industry receptiveness? Comparability?
- Considerations for processes and internal controls

Lease Accounting Project

Technical Guidance:

- In July 2006, the FASB Board added a project to comprehensively reconsider existing guidance for leases (FAS 13)
- Will be a joint project with the International Accounting Standards Board
- Starting point for project is G4+1 paper
- Current interest in eliminating bright-line, all or nothing type standards that use form rather economic representations.
- Lessee and lessor accounting to possibly be addressed in 2 phases (currently both to be addressed together)
- Early 2008 – Position Paper (Discussion Draft) to be developed and circularized (timing tentative and dependent on number of factors)

Lease Accounting Project (continued)

Points to consider:

- Potential impact to change view of real estate significantly
- Lease versus buy decisions by companies could be affected
- Retail sector and sale/leaseback transactions could be adversely affected as a result of the reduction of the “financial statement benefits”
- From lessee perspective, likely outcome is that lease obligations associated with substantially all leases will be on balance sheet
- From lessor perspective, a possible outcome is unbundling of lessor’s assets into a receivable and unguaranteed residual to be separately accounted for.
- After completion of Project, tangent issues could potentially be addressed including FAS 66, *Sales of Real Estate*

Pending FASB Projects
(Proposed Standards, Interpretations and FSPs)

Pension accounting (Phase II)

Accounting for transfers of financial assets

Several projects addressing derivatives

Earnings per share

SEC – What's on the Horizon

Changes at all levels

Recent changes

- Commissioner Cynthia Glassman announced her intention to leave at the completion of her term.
- President Bush nominated Kathleen Casey, current staff director and counsel for the Senate Banking Committee.
- Conrad Hewitt named new Chief Accountant.

Executive Compensation & Related Party Disclosures

Technical Guidance:

SEC issued new rules to revise disclosure rules for:

- Executive compensation
- Director compensation
- Related party transactions
- Director independence
- Corporate governance matters
- Security ownership of officers and directors

Impacts disclosure in proxy statement, annual reports and registration statements.

- Intended to be written in “plain English”

Executive Compensation & Related Party Disclosures (continued)

Technical Guidance:

- Compensation, Discussion and Analysis section now required. This will address objectives and implementation of executive compensation including stock option disclosure.
- Executive Compensation - 3 yr summary for CEO, CFO and the 3 other highest paid executive officers of the following items:
 - 1) Summary compensation over the last 3 yrs
 - 2) Holding of outstanding equity related interests received as compensation that are source of future gains
 - 3) Retirement plans, other post-employment payments & benefits

Director Compensation – similar information required for 1 yr only

Executive Compensation & Related Party Disclosures (continued)

Points to Consider:

- Companies are reviewing equity award grant policies programs to minimize disclosure impact by referencing to policies. Consultation with legal counsel is strongly encouraged.

SAB 108, Guidance for Quantifying Financial Statement Misstatements

Technical Guidance:

Requires use of both “Rollover” and “Iron Curtain” approach (“dual approach”)

- Rollover method is an income statement approach
- Iron curtain method is a balance sheet approach
- If either approach is material, adjustment is required

Early application is encouraged for any interim period of the fiscal year ending after November 15, 2006 (i.e. 3rd quarter for calendar year ends)

Transition allows for cumulative adjustment to Retained Earnings

SAB 108, Guidance for Quantifying Financial Statement Misstatements (continued)

Technical Guidance (continued):
SAB 74 disclosures

Transition disclosures

- Nature and amount of individual items
- When and how individual items arose

SAB 108, Guidance for Quantifying Financial Statement Misstatements (continued)

Points to Consider:

- Work with management to evaluate prior year SUD and determine nature of items
- If material misstatement exists after recording the adjustment, prior year financial statements should be corrected even though impact is immaterial to prior period
 - amended next time the financial information is filed
- Adjustments discovered in current year related to prior year result in the need to reassess prior SUD
- Upon adoption, for those applying cumulative effect adjustment, there will focus on decisions made historically for materiality and potential second guessing of those decisions by parties (Regulators, competitors, shareholders and analysts).

SEC Comment Letter process and trends

SEC is required under Sarbanes-Oxley to review companies every three years

- Depth/scope varies – many reviews are “targeted”

Focus is on periodic reports due to Automatic Shelf Registration

- Still reviewing IPOs, but routine S-3 reviews are less frequent

Responses requested in 10 days, but easily adjusted to accommodate registrant wishes

- Thoroughness and thoughtfulness of response trumps speed
- Responses need to be fact specific; avoid “industry practice comparisons”

Comment letters

- Staff is sending closing letters to the registrant
- Publicly available in Edgar when process is completed

SEC Comment Letter process and trends (continued)

Increased transparency, more in-depth analysis and plain-English discussion in MD&A:

- Executive overview
- Focus on individually material factors
- Discuss estimates/assumptions
- More in-depth analysis of operating cash flows
- Identify and discuss trends which may have a material impact on future operating results and liquidity
- Quantify to the fullest extent each of the reasons causing variances
- Disclosure for unresolved staff comments

SEC Comment Letter process and trends (continued)

MD&A

- Critical accounting estimates and assumptions are based on matters that are highly uncertain. For this reason, you are **required to analyze their specific sensitivity to change**, based on other outcomes that are **reasonably likely** to occur and would have a material effect on financial condition or operating performance and provide quantitative as well as qualitative disclosure when quantitative information is reasonably available and will provide material information to investors.
- Accounting estimates could include consolidation decisions, loss contingency accruals, revenue recognition, impairment

SEC Comment Letter process and trends (continued)

BUSINESS COMBINATIONS AND INTANGIBLE ASSETS

- Purchase price allocation – need to identify intangible assets
- Provide support for finite-lived vs. indefinite-lived intangibles, useful lives and amortization methods
- Disclosing that purchase price allocation is preliminary w/o explaining why
- If reliance on an independent appraisal is discussed in disclosure, identify and include a consent from appraisal firm

SEC Comment Letter process and trends (continued)

Non-GAAP

We note that you present your non-GAAP measures and reconciliation in the form of statements of income. These formats may be confusing to investors as they reflect several non-GAAP measures, including adjusted operating expenses, adjusted income from operations, adjusted net operating margin, adjusted income tax provision, adjusted net income and adjusted net income per share, which have not been described to investors. In fact, it appears that management does not use these non-GAAP measures but they are shown here as a result of the presentation format.

- To eliminate investor confusion, please remove the non-GAAP statements of income from all future filings and instead disclose only those non-GAAP measures used by management that you wish to highlight for investors, with the appropriate reconciliations and disclosures.

SEC Comment Letter process and trends (continued)

Non-GAAP

You disclose in the financial statements the effect of stock-based compensation expense on both basic and diluted earnings per share. These measures appear to be non-GAAP in nature. You should not present non-GAAP measures in your financial statements or in the accompanying notes. Refer to Item 10(e)(1)(ii)(C) of Regulation S-K. Please revise future filings to comply.

SEC Comment Letter process and trends (continued)

Segment reporting

- Information provided to CODM but “not used”
- Assertions of only “one segment”
- The Staff will request a copy of the CODM package
 - The SEC staff also looks at the registrant’s website and articles in outside publications for inconsistencies with respect to segment presentation.

SEC Comment Letter process and trends (continued)

Statement of Cash Flows

Increase in attention by regulators and investors

- SEC Staff has discussed cash flows issues in recent speeches
- Materiality considerations

SEC Comment Letter process and trends (continued)

Cash Flows

We believe that the statement of cash flow guidance prohibits the presentation in the body of the Statement of Cash Flows of cash flows that did not actually occur and that such items should be disclosed as a non-cash investing activity.

404 - Year 2 – Results

Number of Accelerated Filers with Adverse Reports

Year	Total 404 Reports	Adverse Reports	Percentage
2004	3,633	566	15.6%
2005 (Through May 1, 2006)	2,919	199	6.8%

404 - Year 2 – Results (continued)

Industry Sector	Adverse Reports		Industry Total		% Adverse	
	2004	2005	2004	2005	2004	2005
Banking & Capital Markets	57	17	484	469	12	4
Insurance	10	8	136	141	7	6
Investment Management	1	0	14	13	7	0
Real Estate	21	7	197	205	11	3

404 Year 2 – Results (continued)

Most Frequent Material Weaknesses

- Accounting documentation, policy and/or procedures
- Control environment
- Competency, training and sufficiency of accounting resources
- Information technology, software, security and access
- Segregation of duties
- Presentation and classification of the Statement of Cash Flows
- Revenue recognition
- Income tax accounting
- Derivative financial instruments
- Related parties
- Inventory and cost of sales

404 Next Steps

Technical Guidance

- May 10, 2006 SEC Roundtable on Second-Year Experiences with Internal Control Reporting and Auditing Provisions
- May 17, 2006 Press Releases from the SEC/PCAOB on Next Steps for Sarbanes-Oxley Implementation
- Concept Release on matters to be subject of management assessment guidance - issued July 11, 2006

Risk and Control Identification

Nature, timing and extent of management's evaluation

Appropriate levels of documentation to support the assessment

Sensitivity to accelerated filers who have previously performed assessments

404 Next Steps (continued)

Technical Guidance:

- Issuance of COSO Framework for Smaller Companies - July 2006
- Timetable on issuance of final management assessment guidance unclear
- Modifications to PCAOB Auditing Standard 2 anticipated concurrently with management assessment guidance
- Relief from Section 404 Compliance for Smaller Companies (Non Accelerated Filers):

Current rule - initial management assessment and auditor attestation for fiscal years ending on or after July 15, 2007

Proposed change - initial management assessment for fiscal years ending on or after December 15, 2007

Proposed change - initial auditor attestation for fiscal years ending on or after December 15, 2008

404 Next Steps (continued)

Points to Consider:

- Focus for 2006 Sarbanes Oxley work has been to:
 - Implement a top-down approach
 - Vary the nature, timing and extent of control testing including increased reliance on management's testing
 - Emphasize the integration of the audit of internal control with the audit of the financial statements
- Pending Guidance and Rule changes will not impact December 31, 2006 engagements
- SEC focus appears to be on "getting 404 right" rather than pursuing an exemption for smaller companies
- Business and legislative activity still in pursuit of limits/repeal of Sarbanes-Oxley

Audit committee best practices for real estate companies

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Closing remarks

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