NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

November 1, 2004

Mr. Lawrence W. Smith
Director of Technical Applications and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

File Reference No. EITF0313

Dear Larry:

Executive Summary

The National Association of Real Estate Investment Trusts (NAREIT) has reviewed the draft of EITF Abstract Issue 03-13 (the Abstract) and believes that the current application of Statement of Financial Accounting Standards 144 *Accounting for Impairment or Disposal of Long-Lived Assets* (SFAS 144) to real estate companies that own and operate investment property creates an issue that is very similar to the conceptual and reporting issues that the Abstract addresses. The fundamental issue is that the cash inflows and/or outflows eliminated by dispositions of many investment properties are replaced through the acquisition of like-kind properties and, therefore, reporting these regular dispositions as discontinued operations does not faithfully represent the financial impact of the business transaction on the reporting entity.

NAREIT is the national trade association for real estate investment trusts (REITs) and other publicly traded real estate companies. Members include REITs and other businesses that develop, own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses. The business of developing, owning and operating income-producing property regularly involves the disposition of individual or groups of properties from a company's portfolio and the replacement of these properties with like-kind properties. In this context, the accounting standards for property dispositions are important to producing useful and relevant financial reports for publicly traded real estate companies.

The current interpretation and application of SFAS 144 to companies that own and operate investment property has produced financial statements that are at best confusing and potentially misleading. The manner in which SFAS 144 is being applied to real estate has resulted in virtually every property sale being reported in *Discontinued Operations.* This reporting, which requires the constant

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reclassification of operating results, has given financial statement users the impression that there may be a change in the business plans of the reporting entity and, as a result, a significant change in prospective operating results. In the great majority of cases, this is not true. As further discussed below, real estate companies that own and operate investment property regularly dispose of mature properties in order to reinvest the capital raised by the disposition in properties having greater profit potential. The cash flows generated by the replacement property result in "migration" as used in paragraph 6.a. and defined in footnote 3 of the Abstract. NAREIT requests that the EITF consider expanding the discussion in the Abstract to clarify that its guidance may be applicable to components whose cash flows are replaced by cash flows from similar components – regardless of the similarity of customers and geographic region.

Discussion

NAREIT responded to the original exposure draft of SFAS 144 and followed up that response with a letter to the FASB's Director of Research and Technical Activities on December 27, 2001. A copy of each of these letters is attached.

The follow-up letter fully explains issues created by the requirement that virtually every investment property qualifies as a "component" as defined by the standard. The core issue is that the current application of SFAS 144 to most companies that own and operate investment property is causing confusion as to the reporting entity's business plans and its future cash flows. These companies regularly recycle capital through the disposition of more mature properties and reinvesting the proceeds in properties having greater cash flow potential. In many cases, the same tenants lease space in the property disposed of and the replacement property. This is especially true of larger REITs who maintain relationships with national and international office and retail tenants. While this capital recycling enhances future cash flows, the resulting cash flows are generated by the ongoing rental of space in similar properties and, in some cases, to the same tenants. We believe that the results of this recycling are very similar to the "migration" of cash flows as discussed in paragraph 6, footnote 3 of the Abstract and that they produce similar reporting issues.

The definition of "migration" indicates " there is a presumption that if the ongoing entity continues to sell a similar commodity on an active market after the disposal transaction, the revenues (or) costs would be considered a migration." This is precisely what is occurring with respect to many real estate companies. The rental revenue stream from renting space [the industry's commodity] continues after the disposition through the acquisition and rental of similar property.

Reporting these regular sales of properties as discontinued operations gives financial statement users the impression that the recurring disposition of properties is not an integral and regular part of owning and operating an investment property company. In reality the disposition of an investment property by an investment property company represents the regular realization of value created and enhanced through the effective leasing and management of properties by the entity. The proceeds from these dispositions are reinvested in comparable properties producing the same benefit, often times to the same user or types of user. This is similar to any manufacturer that creates value in excess of the costs of products within a short-term period. The difference is that, during the operating period, the owner of investment property receives rental revenue.

A recent study of dispositions by 144 public REITs, representing 77% of all public REITs and 89% of the REIT market by equity market capitalization, indicates that, during 2001, 2002 and 2003 (432 annual reporting periods) gains/losses from property dispositions were reported in 276, or 64%, of the periods. Fifty-five of the 144 companies reported gains/losses in each of the three years. Similarly, "discontinued operations" were reported in 63% of the periods and 62 companies reported "discontinued operations" in all three periods. The great majority of these dispositions represent the regular recycling of capital into similar investment properties.

Other Considerations

Global Convergence

The International Accounting Standards Board recently issued International Financial Reporting Standard No. 5 *Non-current Assets Held for Sale and Discontinued Operations* (IFRS 5). Question 8 of the exposure draft of this standard requested that respondents specifically provide their views with respect to "classification as a discontinued operation." The question raised the issue of reporting regular sales of immaterial components as discontinued operations and included the following discussion:

> *The Exposure Draft proposes that a discontinued operation should be a component of an entity that either has been disposed of, or is classified as held for sale, and:*
> *(a) the operations and cash flows of that component have been, or will be, eliminated from the ongoing operations of the entity as a result of its disposition, and*
> *(b) the entity will have no significant continuing involvement in that component after its disposal.*
>
> *A component of an entity may be a cash-generating unit or any group of cash-generating units. (See paragraphs 22 and 23.)*
>
> *These criteria could lead to relatively small units being classified as discontinued (subject to their materiality). Some entities may also regularly sell (and buy) operations that would be classified as discontinued operations, resulting in discontinued operations being presented every year. This, in turn, will lead to the comparatives being restated every year. Do you agree that this is appropriate? Would you prefer an amendment to the criteria, for example adding a requirement adapted from IAS 35 Discontinued Operations that a discontinued operation shall be a separate major line of business or geographical area of operations, even though this would not converge with SFAS 144 Accounting for the Impairment or Disposal of Long-Lived Assets. How important is convergence in your preference?*

> *Are there other aspects of these criteria for classification as a discontinued operation (for example, the elimination of the operations and cash flows) appropriate? If not, what criteria would you suggest, and why?*

NAREIT responded to this exposure draft indicating that it preferred that the results of regular sales of insignificant components not be reported as discontinued operations. The comment letter suggested that the rules of classification as a discontinued operation should only apply to significant components of an entity's business and not to individual sales of long-lived assets. A copy of this comment letter is attached. On March 31, 2004, the IASB issued IFRS 5. In the final rule, the IASB agreed with the comments expressed by NAREIT and others by concluding that a discontinued operation should be a major line of business or geographical area of operations.

While we understand that the Issue 03-13 is not intended to reconcile international standards with U.S. GAAP, we do not understand why the EITF would issue guidance that confirms accounting practice that is so inconsistent with the March 2004 IASB conclusions. In fact, it seems contrary to the FASB's commitment to the global harmonization of reporting standards to issue this Abstract without more broadly considering the criteria for reporting a disposition as a discontinued operation. Consideration of Issue 03-13, together with the most recent thinking of international standards setters with respect to reporting discontinued operations, provides the EITF an opportunity to enhance global standards harmonization and eliminate a significant issue creating conflict between the U.S. and international standards.

Rules-Based vs. Principles-Based Standards

In addition to conclusions in the draft of the Abstract perpetuating differences between U.S. and international standards, the Abstract is highly rules-based rather than principles-based. As indicated in the first paragraph of this letter, the Abstract provides a number of narrow rules that may modify the application of SFAS 144 to some extent without addressing more broadly the issue of reporting dispositions where entity cash flows are replaced. More specifically, the requirement that new cash flows must be generated from "specific customers of the disposed component" (lessees in our industry's case) and in the same geographic region does not address the situation in which the entity's cash flows are replaced through the sale/lease of similar products. Establishing these arbitrary rules also seems contrary to the FASB's announced movement toward principles-based standards.

Administrative and Audit Complexity

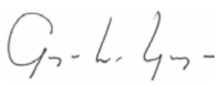
Reporting regular dispositions of insignificant components as discontinued operations and continually reclassifying previously reported operating results creates administrative burdens, complications in communicating operating results and complexities with respect to the audit process. Focusing on the external audit process, an entity's audit firm must audit these regular reclassifications. This becomes especially burdensome in the process of obtaining comfort letters when issuing securities. Further, many in the financial community believe that rotation of audit firms by public companies may be in the best public interest. Based on a great deal of experience when it was necessary to appoint new auditors to replace Arthur Andersen LLP, the new auditor was not allowed to rely on the Andersen opinion on prior periods when elements of prior period financial statements were restated or reclassified. This additional audit burden and cost may be a hurdle to auditor rotation.

<u>Summary</u>

NAREIT respectfully requests that the EITF consider broadening its evaluation of issues created by reporting regular, insignificant dispositions as discontinued operations – especially when cash flows from disposed properties are replaced through the acquisition of similar properties.

If you have any questions regarding this request or if we can support a positive response to this request, please contact me at 202-739-9432 or gyungmann@nareit.com.

Sincerely,



George L. Yungmann
VP, Financial Standard

NATIONAL

ASSOCIATION

OF

REAL ESTATE

INVESTMENT

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October 13, 2000

Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
File Reference No. 210-D
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Proposed Statement of Financial Accounting Standards – Accounting for the Impairment or Disposal of Long-Lived Assets and for Obligations Associated with Disposal Activities

Dear Mr. Lucas:

The National Association of Real Estate Investment Trusts (NAREIT) is pleased to have the opportunity to respond to the Financial Accounting Standards Board's (the Board) Exposure Draft (ED) of the proposed policy on asset impairment and disposal. NAREIT is the national trade association for real estate investment trusts (REITs) and other publicly traded real estate companies. Members include REITs and other businesses that develop, own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service these businesses.

General Comments

The business of developing, owning and operating income-producing property involves long-lived assets and their disposal. In this context, the accounting standards for asset impairment and disposal are of vital importance to producing useful and relevant financial reports for publicly traded real estate companies.

NAREIT supports the Board's efforts to enhance the usefulness and relevance of financial reporting by developing standards that would supersede FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, as well as the accounting and reporting provisions of APB No. 30 that address the disposal of a segment of a business. However, as discussed below, we believe there are certain aspects of the proposal that should be amended to facilitate its implementation.

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Specific Comments

1. Exchanging an asset (group) for a similar productive asset (group):

Paragraph 29 of the ED requires that when an asset (group) is exchanged, a loss shall be recognized if the carrying amount of the asset (group) exceeds its fair value. That loss, if any, is in addition to, rather than a substitution for, any impairment losses required to be recognized while the asset (group) was held and used. NAREIT supports the use of fair value in this situation, as well as more broadly as it relates to accounting for investment property. We believe that the foregoing recognition and measurement guidance also should apply where the fair value of the asset (group) exchanged/surrendered is greater than its carrying amount. Further, if the fair value of the asset (group) received is "more evident" (see comment below) than the carrying amount of the asset (group) surrendered, the asset (group) received should be recorded at its fair value and the related gain recognized. At a minimum, such gain should be recognized to the extent of any previous impairment write-down recognized while an exchanged asset (group) was held and used. This position is supported by paragraph 18 of APB 29, which states that, "the fair value of the asset received should be used to measure cost if it is more clearly evident than the fair value of the asset surrendered."

In the event the final standard retains the use of fair value to measure only losses on asset (group) exchanges as proposed in the ED, we believe that such loss should be limited to the difference between the fair value of the asset (group) received and the carrying amount of the asset (group) exchanged when the fair value of the asset (group) received is "more evident" than the fair value of the asset (group) exchanged. Again, this position is supported by paragraph 18 of APB 29.

2. Asset sold or liability settled separately from a group:

Pursuant to paragraph 40 of the ED, if an entity sells an individual asset previously classified as held for sale as part of a group or settles before its maturity an individual liability previously included as part of the group, the remaining assets and liabilities of the group shall not continue to be measured as a group. The remaining assets will continue to be held for sale and measured individually at the lower of their carrying amounts or fair values less cost to sell. The remaining liabilities will be measured individually at their carrying amounts.

NAREIT believes that the final standard should permit one-off asset sales and liability settlements that do not otherwise change management's initial plan to sell the group of assets and liabilities. The one-off asset sales or settlements should not disqualify the continued grouping of the remaining assets and liabilities so long as all other criteria continue to be met.

3. When to test an asset (group) for impairment:

Paragraph 13 of the ED provides examples for when an asset (group) shall be tested for impairment. Specifically, paragraph 13(f) suggests that an asset (group) shall be tested for impairment when there is "[a] more-likely-than-not expectation that it will be sold or otherwise disposed of significantly before the end of its previously estimated useful life."

NAREIT is concerned that this indicator of when to test for impairment is much too subjective for long-lived assets (i.e., assets with useful lives beyond 10 years). For an investment property with a useful life of 40 years, it would be impossible for management to represent in the early years of the property's life whether or not the property might be sold within the first 20 years. We suggest removing this indicator or changing the language as follows:

"A more-likely-than-not expectation that it will be sold or otherwise disposed of **at the earlier of *(a)*** significantly before the end of its previously estimated useful life **or *(b) within five years from the reporting date***."

4. The term "useful life" does not appear in boldface type the first time it appears in the document (see paragraph 11).

Issues on which the Board has requested comments

Issue 1: Using the expected cash flow approach in developing estimates of future cash flows to test an asset (group) for recoverability.

Although NAREIT believes the expected cash flow approach is appropriate on a theoretical basis, we think the existing standard that allows for either a "best estimate" or an "expected cash flow method" remains appropriate. We believe that a company should be permitted to use an approach that is based on how it evaluates its business.

In the case of the real estate industry, the utilization of cash flow modeling is well established and currently an integral part of managing the business through budgets, as well as evaluating development, acquisition and disposition opportunities. In addition, long standing real estate appraisal/valuation methodology utilizes best estimates of future cash flows. Underlying independent appraisal methodology is the concept of "highest and best use," which requires that the estimate of value reflect the asset's highest and best use and a "best estimate" of value. When developing cash flow estimates, real estate companies and appraisers calculate a "best estimate" that involves numerous assumptions such as lease renewal expectations, market conditions (changes in market rental rates), the economic environment (inflation rates), and operating expenses. Probabilities regarding these assumptions are reflected in the best estimate of cash flow.

NAREIT does not believe that requiring multiple cash flows, weighted by their likelihood of occurrence, would improve the quality of the ultimate cash flow used to calculate recoverability. To the contrary, assigning probabilities to various cash flow scenarios would create complexity by increasing variables, be extremely subject to manipulation, and very difficult, if not impossible, to audit.

Further, requiring companies that use "best estimate" cash flow models for budgeting and forecasting purposes to use a probability-weighted expected cash flow method would be burdensome and may not yield the most appropriate cash flow estimates. Again, auditing the accuracy of a probability percentage would be virtually impossible. Conversely, a "best estimate" cash flow model used for budgeting and forecasting purposes could be reviewed based on historical results and the reasonableness of future assumptions.

It seems more logical to use management assumptions incorporated into actual business decisions regarding an asset that can be more readily evaluated during the audit process to determine recoverability of an asset, than to impose another method which would increase complexity, provide the ability to manipulate the outcome, and reduce the auditability of the cash flow stream. Existing rules that allow for either a "best estimate" or the use of an "expected cash flow method" remain appropriate.

NAREIT also believes that the approach used to test for recoverability should be consistent with the approach used to measure impairment. Under the proposal, a company that uses a traditional cash flow estimate to measure impairment must use the expected cash flow approach to test for recoverability. We believe that this results in an effort that is duplicative and not necessary.

<u>Issue 2: Definition of "primary asset" of an asset group.</u>

NAREIT has no comment on this issue.

<u>Issue 3: "Held for sale" criteria.</u>

The criteria in paragraph 30(e) related to assets to be sold as a group states:

> Assets to be sold as a group are expected to be sold to a single buyer. The estimated net proceeds expected to result from that sale are higher than those that would result if the assets were sold individually.

There are many reasons a company may want to sell a group of assets for less than the amount that could be obtained if they were sold individually. Reasons may include the ability to include in the group assets with a lower return-on-capital potential, the exiting out of a geographic area or product type, and the sale of strategically aligned assets as a group. NAREIT believes that FASB should eliminate the last sentence of paragraph 30(e).

Issue 4: Discontinued Operations

NAREIT has no comment on this issue.

Issue 5: Obligations Associated with Disposal Activities

NAREIT has no comment on this issue.

Issue 6: Public Hearing

The ED contains accounting policies that have not previously been required. NAREIT believes that the Board would benefit by hearing how the proposed accounting could impact companies.

Concluding Remarks

Although we consider all of the foregoing issues to be important, we urge the Board to especially consider the recognition of gain/loss upon exchange of an asset (group) for a similar productive asset (group). We applaud the Board's continued use of fair value to measure the impairment of long-lived assets, and encourage the Board to consider broadening its use of fair value for investment property, possibly in a manner similar to the International Accounting Standards Committee's adoption of International Accounting Standard No. 40, *Investment Property*.

NAREIT appreciates the opportunity to participate in the Board's considerations with respect to accounting for asset impairment and disposal. If you should have any questions regarding this response, please contact George Yungmann, NAREIT's Vice President, Financial Standards, at (202) 739-9432, David Taube, NAREIT's Director, Financial Standards at (202) 739-9442, or me at (908) 497-2015.

Sincerely,

Barry Lefkowitz
Executive Vice President, Chief Financial Officer
Mack-Cali Realty Corporation
Co-Chair, NAREIT Accounting Committee

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

December 27, 2001

Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Application of SFAS 144 to Discontinued Operations

Dear Mr. Lucas:

The National Association of Real Estate Investment Trusts (NAREIT) would like to bring to your attention its concerns regarding the changes Statement of Financial Accounting Standards No. 144 (SFAS 144), *Accounting for the Impairment or Disposal of Long-Lived Assets*, could require for the reporting of discontinued operations. We understand that certain parties have interpreted SFAS 144 to require the extension of discontinued operations to **all** "components" of an entity, rather than **only** to "significant components." For real estate companies that frequently dispose of "insignificant components," this reporting could create considerable confusion among financial statement users. NAREIT requests that the Board clarify its intent regarding the reporting for the disposal of investment property judged to be an insignificant component of an entity.

NAREIT is the national trade association for real estate investment trusts (REITs) and other publicly traded real estate companies. Members include REITs and other businesses that develop, own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service these businesses. The business of developing, owning and operating income-producing property regularly involves the disposition of individual or groups of properties from a company's portfolio. In this context, the accounting standards for property dispositions are important to producing useful and relevant financial reports for publicly traded real estate companies.

When the Board issued its July 2000 Exposure Draft of the proposed standard, the reporting for discontinued operations was applicable or extended **only** to a "significant component of an entity." Further, paragraph 42 of the proposal

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specifically stated: "In assessing whether a component of an entity is significant, an entity shall consider all relevant facts and circumstances, quantitative and qualitative." NAREIT's comment letter submitted in response to the proposal did not address this issue because the use of "significant" with regard to components of a business would have allowed for judgment in determining whether a disposition would be significant and, therefore, be reported as a discontinued operation. Based on the foregoing, many dispositions of individual or groups of properties would not be judged to be significant.

As indicated in SFAS 144's basis for conclusions (paragraph B103), "the Board chose not to define the term *significant* to allow for judgement in determining whether, based on facts and circumstances unique to a particular entity, a disposal transaction should be reported in discontinued operations." However, the language in paragraph 42 of the Exposure Draft that would allow for this judgement was eliminated from the final standard. Some believe that a literal reading of SFAS 144 does not provide the latitude contemplated in paragraph B103.

Under SFAS 144 provisions for reporting discontinued operations, a component "comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity." Consistent with example 15 of Appendix A, some have interpreted this scenario to mean that if a real estate company owning and operating multiple properties within a market area disposes of one property in that market, the disposal would not have to be reported as discontinued operations because the operations have not been eliminated. In many cases, the operations of one property cannot be clearly distinguished because multiple properties located within a market area typically share corporate resources such as property management, leasing, security, and maintenance personnel.

Further, in many cases the cash flows of the disposed property are replaced through exchange, purchase, or improvement of another property within the same or different market. In any of these situations, the capital is reinvested to replicate and/or enhance the cash flows associated with the disposed property, rather than distributed to shareholders.

If the Board intended that the disposal of an individual property or an insignificant group of properties be reported as discontinued operations, we believe this would create significant confusion among financial statement users. It is not unusual for real estate companies to frequently dispose of properties. In a recently completed study, we reviewed the frequency of reported gains/losses from property dispositions by 40 large real estate companies during 1998, 1999 and 2000. Of the 120 annual periods (40 companies, 3 years) reviewed, property dispositions were reported in 103 (86%) of the annual periods. Further, 28 (70%) of the companies reported property dispositions in each of the three years reviewed. Treating **all** of these dispositions as discontinued operations and, therefore, constantly restating previously reported operating results, would cause a great deal of confusion.

Further, we believe that reporting discontinued operations suggests a shift in a company's business plan and, therefore, should not be used for insignificant dispositions. For example, it would be inappropriate for a real estate company that owns and operates hundreds of office buildings to report the disposition of one building or any number of buildings having an insignificant effect on a company's cash flows as discontinued operations.

We respectfully request that the Board clarify its intention "to allow for judgement in determining whether, based on facts and circumstances unique to a particular entity, a disposal transaction should be reported in discontinued operations." We do not believe that the examples in SFAS 144 provide adequate clarifying guidance.

NAREIT appreciates the opportunity to continue to participate in Board's standard setting process. This comment letter has been reviewed and approved by NAREIT's Best Financial Practices Council. If you have any questions regarding this response, please contact George Yungmann at (202) 739-9432 or David Taube at (202) 739-9442.

Respectfully Submitted,

George L. Yungmann
Vice President, Financial Standards

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

October 20, 2003

Ms. Anne McGeachin
Project Manager
International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Re: Proposed International Financial Reporting Standard – *Disposal of Non-Current Assets and Presentation of Discontinued Operations*

Dear Ms. McGeachin:

The National Association of Real Estate Investment Trusts® (NAREIT®) is pleased to have the opportunity to respond to the International Accounting Standards Board's (the Board) Exposure Draft, *Disposal of Non-Current Assets and Presentation of Discontinued Operations* (ED 4). NAREIT is the national trade association for real estate investment trusts (REITs) and other publicly traded real estate companies. Members include REITs and other businesses that develop, own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service these businesses.

The business of developing, owning and operating income-producing property involves long-lived assets and their disposal. In this context, the accounting standards for asset disposal and the presentation of discontinued operations are of vital importance to producing useful and relevant financial reports for publicly traded real estate companies.

NAREIT supports the Board's efforts to converge accounting standards around the world. It welcomes the Board's efforts to enhance the usefulness and relevance of financial reporting by developing standards that would reduce differences between International Financial Reporting Standards and U.S. Generally Accepted Accounting Principles, specifically in consideration of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144)*.

However, in response to Question 8, *Classification as a discontinued operation*, we believe that it is not appropriate for comparative financial statements to be restated every time a property is disposed. It is not unusual for real estate companies to frequently dispose of properties. Companies often acquire properties with substantial vacancy, improve and lease-up the properties utilizing

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the expertise of their asset and property management personnel and then sell the asset to an institutional or other investor who requires a consistent return from a stabilized asset. The sale proceeds are then typically reinvested in new properties, repeating the cycle. To illustrate this point, we have reviewed the frequency of reported gains/losses from property dispositions by 40 large real estate companies during 1998, 1999 and 2000. Of the 120 annual periods (40 companies, 3 years) reviewed, property dispositions were reported in 103 (86%) of the annual periods. Further, 28 (70%) of the companies reported property dispositions in each of the three years reviewed. It is clear that property dispositions represent an ongoing activity for many real estate companies and are integral to their business strategy. Investors have applauded the strategy of recycling capital through the sale of mature properties and reinvesting the proceeds in new properties. We do not believe that this type of disposition activity represents what investors typically view as "discontinued operations." Treating **all** of these dispositions as discontinued operations and, therefore, constantly restating previously reported operating results, causes a great deal of confusion to financial statement users.

Further, we believe that reporting discontinued operations suggests a shift in a company's business plan and, therefore, should not be used for insignificant dispositions. For example, it is inappropriate for a real estate company that owns and operates hundreds of office buildings to report the disposition of one building or any number of buildings having an insignificant effect on a company's cash flows as discontinued operations.

We believe that the rules of classification as a discontinued operation should only apply to significant components of an entity's business and not to individual sales of long-term assets. In assessing whether a component is significant, an entity should consider all relevant facts and circumstances, both quantitative and qualitative. We respectfully request that the Board allow for judgment in determining whether, based on facts and circumstances unique to a particular entity, a disposal transaction is significant and should be reported in discontinued operations.

NAREIT appreciates the opportunity to continue to participate in Board's standard setting process. This comment letter has been reviewed and approved by NAREIT's Best Financial Practices Council[1]. If you have any questions regarding this response, please contact George Yungmann at (202) 739-9432 or Gaurav Agarwal at (202) 739-9442.

Sincerely.

George Yungmann
V.P. Financial Standards

[1] The Best Financial Practices Council is a group of financial executives from real estate companies, investment and advisory firms, and audit firms. The Council studies and formulates financial reporting practices that are best suited for the industry and prepares a recommendation to the NAREIT Executive Committee and Board of Governors for the industry to adopt a set of specific practices.

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Loretta V. Cangialosi
Vice President and Controller

November 1, 2004

Project Manager
Financial Accounting Standards Board
401 Merritt 7
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Norwalk, CT 06856-5116

Subject: Draft EITF Abstract Issue No: 03-13, Applying the Conditions in Paragraph 42 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, In Determining Whether to Report Discontinued Operations

Dear Sir/Madam:

Pfizer is a research-based, global pharmaceutical company with its principal place of business in New York. We discover, develop, manufacture and market leading prescription medicines for humans and animals and many of the world's best-known consumer products. The Company's 2003 total revenues were $45.2 billion and its assets were $116.8 billion. We appreciate the opportunity to respond to the guidance provided in the draft EITF on Applying the Conditions in Paragraph 42 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, in Determining Whether to Report Discontinued Operations, as we are extremely committed to the EITF and its objectives.

Overall, we support the EITF's objective to improve guidance surrounding paragraph 42 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (Statement), in determining whether to report discontinued operations. Consistent application and interpretation of the Statement ensures comparability among entities and the representational faithfulness of reported financial results. We are concerned, however, that the guidance, as drafted, could preclude certain transactions with *transitional* services agreements from being recorded as part of discontinued operations which would qualify under current guidance. This would also be in conflict with the intent of the Statement as well as the intent of management related to its ongoing business. We believe greater emphasis should be focused on management's *ability and intent* to exit certain definable activities since, in certain situations in the pharmaceutical industry, it may not be possible to completely do so in the period prescribed. We have proposed clarifying language for your consideration.

Attached are our comments, which include responses to the issues included in the "Notice for Recipients of This Draft EITF Abstract."

Once again, we appreciate this opportunity to comment and encourage the EITF to continue to engage its constituents. If requested, we would be pleased to discuss our observations with you at any time.

Very truly yours,

Loretta V. Cangialosi

Loretta V. Cangialosi
Vice President and Controller

cc: David L. Shedlarz
Executive Vice President and Chief Financial Officer

Attachment

Draft EITF Abstract Issue No: 03-13, "Applying the Conditions in Paragraph 42 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, In Determining Whether to Report Discontinued Operations"

General Comments:

As detailed in Concepts Statement No. 1: *Objectives of Financial Reporting by Business Enterprises*, we believe financial statements are most beneficial to users when the statements "provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions." It further recognizes that "management knows more about the enterprise and its affairs…and accordingly can often increase the usefulness of financial information by identifying certain events and circumstances and explaining their effects on the enterprise."

We are concerned that the proposed guidance of one year after the date the component is actually disposed of for the Assessment Period is too prescriptive in detailing what criteria should be applied to determine what can be classified as discontinued operations, particularly in the case of *Transitional* Services Agreements (TSA's). Since the intent of Statement 144 was to broaden the presentation of discontinued operations to include more disposal transactions so that users could more accurately assess the ongoing operations and cash flows of an entity, we are concerned about the current language of the EITF conclusion.

In certain industries, such the pharmaceutical industry, strict regulations govern the manufacture of products, which has implications for as to how quickly manufacturing operations may be transitioned from the buyer to the seller.

For example, in the US, process validation is required by the Current Good Manufacturing Practice Regulations for Finished Pharmaceuticals, 21 CFR Parts 210 and 211. The FDA defines process validation as follows: Process validation is establishing documented evidence which provides a high degree of assurance that a specific process will consistently produce a product meeting its pre-determined specifications and quality characteristics. This process includes, but is not limited to the preparation of written procedures for production and process control, completion of sampling and testing of in-process materials and drug products, substantiation of processes to prevent contamination of drug products, conclusion of equipment installation qualification studies, and completion of product performance qualification activities. Generally, in situations where the manufacturing process is complex and the technology is state of the art, the time to receive approval to manufacture a drug product could be quite lengthy, <u>usually greater than one year</u>. Therefore, it is highly unlikely that a buyer could acquire a product or a business, assume manufacturing and sell finished product without a TSA. Under the TSA, the seller generally agrees to manufacture a product for a limited period of time. During this period, the buyer maintains the risks and rewards of ownership of the product and works with the regulators to validate its own manufacturing facilities. Once approval is obtained, the buyer typically terminates the TSA and assumes full manufacturing responsibilities. This can also have implications for divestitures involving processes that are extremely complex or require a specialized workforce. Additionally, in many cases, a TSA is indispensable to the execution the overall divestiture.

While the TSA is in effect, the cash outflows may not be substantially different for the seller than prior to the divestiture, depending upon the terms of the agreement. This is particularly true of lower margin product sales. Under the EITF consensus, we are concerned that a TSA with a term necessarily longer than one year could preclude discontinued operations treatment under the "direct cash flow" criteria and/or under the "significant continuing involvement" criteria. We don't believe that this would be the most representationally faithful outcome.

We believe the Assessment Period guidance should be modified to allow treatment as discontinued operations when the entity has the intent and ability to eliminate the operations and cash flows within a timeframe that is appropriate in consideration of the facts and circumstances of the transaction. We suggest the following language:

> Assessment Period
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> The Task Force reached a consensus that the appropriate assessment period should be that period that is required to fully execute the intent of management to eliminate the operations and cash flows of the disposed component. The assessment period should begin when the component initially meets the criteria to be classified as held for sale and should end when all elements of the disposal effort are complete, including so-called transitional services agreements. Although the time required will vary with circumstances, the Assessment Period should usually not exceed one year from the date the component is actually disposed of.

In addition to the proposed language above, we also propose the inclusion of an additional example to help clarify the treatment of TSAs.

> Example XX - An entity develops, manufactures and sells prescription medicines. For that entity, the product level is the lowest level at which the operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. Therefore, the product is a component of the entity.
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> The entity has experienced reduced margins for one of its products due to increased competition in the market. The entity decides to remain in the business of developing, manufacturing and selling prescription medicines, but will divest one product and all associated assets. The product is classified as held for sale at the appropriate date.
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> As part of the divesture agreement, the entity will enter into a Transitional Services Agreement (TSA) for 18 months to supply the buyer with 100% of its product needs at market rates until the buyer's manufacturing facilities have been validated for the production of this product by the appropriate regulatory agency. The terms of the TSA are customary, and the agreement does not provide the ongoing entity with the ability to otherwise be involved in the operation of the disposed component.
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> The entity estimates that the continuing cash flows as a result of a continuation of activities (manufacturing) will result in the ongoing entity recognizing $20 million of costs associated with the production of products to be sold to the disposed component. The entity estimates that the disposed component would have generated the same amount of costs associated with the manufacture of prescription medicines to be sold to third party customers absent the disposal activity.
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> Evaluation:
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> Step 1: Are continuing cash flows expected to be generated by the ongoing entity?
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> > Yes. Continuing cash flows are being generated by the ongoing entity resulting from the sale of manufactured product to the disposed component.
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> Step 2: Do the continuing cash flows result from a migration or continuation of activities?
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> > Yes. The continuing cash flows are the result of a continuation of activities between the ongoing entity and the disposed component, since the ongoing entity will sell the manufactured product to the disposed component. Therefore, an evaluation of the significance of the continuing cash flows should be performed.

Step 3: Are the continuing cash flows significant?

Yes. The entity estimates that the continuing cash outflows will approximate 100% of the cash outflows that would have been generated by the disposed component absent the disposal transaction. The entity believes that 100% is significant.

Step 3a: Considering the facts and circumstances of the disposal arrangement, does the seller have the ability and intent to eventually eliminate the operations and cash flows of the disposed component by the end of the Assessment Period?

Yes, the ongoing entity can demonstrate the ability and intent to eliminate the direct cash flows by the end of the Assessment Period.

Step 3b: Are the transition terms of the disposal arrangement (the disposal conditions), if any, reasonable and customary with respect to the industry and/or complexity of the disposal transaction?

Yes, the length of the disposal transition period is reasonable and customary for the industry.

Step 4: Does the ongoing entity have significant continuing involvement in the operations of the disposed component *past the Assessment Period*?

No. Even though the TSA is likely to be significant to the overall operations of the disposed component, it will not result in the ongoing entity having the ability to significantly influence the operating and (or) financial policies of the disposed component after it is sold, based on the following:

a. The significance of the TSA to the overall operations of the disposed component is mitigated by its intended duration - - the continuing involvement is intended to serve as a transition arrangement, not an on-going business arrangement.
b. The extent to which the ongoing entity is involved in the operations of the disposed component is mitigated by its intended duration - - the continuing involvement is intended to serve as a transition arrangement, not an on-going business arrangement.
c. No rights have been conveyed by the contracts that permit the ongoing entity to exert significant influence over the disposed component's operating and financial policies.
d. The pricing terms of the contract are usual and customary.

Conclusion: Since the ongoing entity can demonstrate the intent and ability to eliminate the direct cash flows by the end of the Assessment Period and will not have a significant continuing involvement in the operations of the disposed component, classification as a discontinued operation would be appropriate.

Our comments to specific questions follow:

Issue 1:

Do you agree that guidance is necessary to assist in applying the criteria set forth in paragraph 42 of Statement No. 144?

As we understand there to be diversity in practice in the application of paragraph 42 of Statement 144, we agree that it is appropriate to provide additional guidance to assist registrants in applying the criteria set forth in the Statement. We believe, however, that this guidance as presented in the draft EITF requires further clarification and flexibility given the complexity of certain transactions. See our general comments above.

Issue 2:

Do you agree with the approach used to determine whether continuing cash flows are direct or indirect cash flows? Do you believe such an approach can be reasonably applied without further application guidance?

We find it unusual that the definition includes an assessment of significance. We understand how "significance" would be important to the final accounting determination, but it seems more logical to define "direct" and "indirect" based on their nature without regard to the quantitative aspect and then prescribe the accounting based on those definitions coupled with an assessment of significance. It seems odd to say that a cash flow stream is direct if it is material and indirect if it is insignificant.

It might be helpful to say that discontinued operations treatment should be disallowed if there are significant direct cash flows or if there is significant continuing involvement.

See also our general comments above.

Issue 3:

Do you agree with the approach used to determine whether continuing involvement constitutes significant continuing involvement? Do you believe such an approach can be reasonably applied without further application guidance?

We believe that the consensus recognizes that judgment is required and we are please to see that there isn't a formula or rigid approach to this area. We would like to see the first bullet of guidance ["significance of the contract or arrangement to the overall operations of the disposed component"] incorporate additional concepts such as, for example, "Significance, nature, intent and term of the contract …"

See our general comments above.

Issue 4:

Do you agree that an assessment period should be provided and, if so, do you agree that the assessment period should include the point at which the component initially meets the criteria to be classified as held for sale through one year after the date the component is actually disposed of?

See our general comments above. We do not believe that a bright-line assessment period should be provided. Every transaction is unique and should be reviewed thoroughly given the specific facts and circumstances. If the EITF believes it would be beneficial for companies to receive direction, then it can be provided, but it should not represent a "bright line" to be followed and adhered to in all circumstances. As previously discussed, TSAs may be executed for a timeframe greater than one year, until the buyer is able to obtain the expertise or approval to operate independently. Consideration should be given to these arrangements which could extend for various time periods.

Issue 5:

Do you believe the disclosure requirements are adequate?

We do not have significant concerns regarding the disclosure requirements. However, we do believe the wording in paragraph 15, second sentence, is confusing as to whether it applies to required disclosures only in situations where discontinued operations treatment is achieved. Further clarification should be provided.

Issue 6:

Do you believe the transition requirements are appropriate?

We believe that the transition guidance is appropriate.

Issue 7:

Do you believe the examples provided in the exhibit to the draft abstract adequately illustrate the application of the consensus?

We believe the examples provided in the exhibit are helpful for registrants to apply the consensus. We would like Example 9 to provide further clarification as shown below and we have suggested an additional example above in our general comments that illustrates the concepts when transitional services agreements are present.

> Example 9 – This example focuses on the impact of a 5 year royalty agreement on the treatment of a sale of the medical device operation. While we understand and agree that this transaction would qualify for treatment as a discontinued operation, we would like further clarification of the various components in the financial statements. Specifically, while the gain/loss on the disposal of the operation as well as the financial results of the operation prior to its disposition would be included in discontinued operations, the royalties received during the 5 years would be classified in continuing operations.

Also, we believe that Exhibit 03-13A should incorporate the concepts included in this letter related to the Assessment Period.