

KILROY REALTY CORP

Form 10-Q/A

November 08, 2005

Table of Contents

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**Amendment No. 1**

**FORM 10-Q/A**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended June 30, 2005**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 1-12675**

**KILROY REALTY CORPORATION**

(Exact name of registrant as specified in its charter)

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**Maryland**  
(State or other jurisdiction  
of incorporation or organization)

**95-4598246**  
(I.R.S. Employer  
Identification Number)

**12200 W. Olympic Boulevard, Suite 200, Los Angeles, California 90064**

(Address of principal executive offices)

**(310) 481-8400**

(Registrant's telephone number, including area code)

**N/A**

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes  No

As of August 12, 2005, 28,924,504 shares of common stock, par value \$.01 per share, were outstanding.

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**Table of Contents**

**EXPLANATORY NOTE**

This Amendment No. 1 on Form 10-Q/A ( Amendment No. 1 ) to the Quarterly Report on Form 10-Q of Kilroy Realty Corporation (the Company ) for the quarterly period ended June 30, 2005 (the Original Filing ) is being filed to restate the Company's consolidated financial statements to mark six interest rate swap and two interest rate cap agreements the Company entered into in 2000 and 2002 to market and to recognize the impact of this mark to market adjustment in the income statement for each period, rather than through other comprehensive income. Prior to entering into these agreements, the Company engaged an independent consulting firm specializing in derivatives to advise the Company with respect to derivatives and hedging matters. The Company consulted closely with the independent derivatives specialist during its preparation of the formal designation of the instruments to ensure that each of the instruments qualified for hedge accounting treatment under Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities ( SFAS 133 ) and the related accounting guidance. Although both the Company and the independent derivatives specialist believed the designation documentation met the requirements under SFAS 133 at the time the derivative transactions were entered into, the Company subsequently determined that the designation documentation does not meet the technical requirements under SFAS 133 to qualify for hedge accounting treatment. As a result, the Company is required to restate prior period financial statements to mark all of these instruments to market and to recognize the impact of this mark to market adjustment in the statement of operations for each period, rather than through other comprehensive income.

In addition, based on a recent review of the Company's accounting treatment for tenant improvements reimbursed by the tenant, the Company is also restating its financial statements to record a capital asset and related depreciation for leasehold improvements constructed by the Company that are reimbursed by the tenants with a corresponding liability for deferred revenue, which will be amortized into rental revenue over the lives of the related leases. In connection with the restatement, certain other immaterial adjustments have also been recorded.

In the Original Filing the Company restated its income from continuing operations per common share included within its consolidated statements of operations for the three and six months ended June 30, 2004 from amounts previously reported to correctly reflect the impact of preferred stock dividends in the calculation of income from continuing operations per common share in accordance with Statement of Financial Accounting Standards No. 128, Earnings per Share, so that income from continuing operations per share is presented net of preferred dividends paid and accrued. The Original Filing also restated the consolidated statements of cash flows for the six months ended June 30, 2004 from amounts previously reported to correct the classification of two items in the consolidated statements of cash flows.

For a more detailed description of the restatements, see Note 14 to the accompanying consolidated financial statements contained in this Amendment No. 1. In connection with the restatements, the Company reevaluated the effectiveness of its controls and procedures and, accordingly, includes revised disclosure in this Amendment No. 1 under Part I, Item 4 Controls and Procedures.

The Company is concurrently filing amendments to its Annual Report on Form 10-K/A for the fiscal year ended December 31, 2004 and its Quarterly Report on Form 10-Q/A for the quarter ended March 31, 2005 also to restate the Company's consolidated financial statements to mark the interest rate swap and interest rate cap agreements the Company entered into in 2000 and 2002 to market and to recognize the impact of this mark to market adjustment in the statement of operations for each affected period, rather than through other comprehensive income, as well as to record a capital asset and related depreciation for leasehold improvements constructed by the Company that are reimbursed by the tenants with corresponding liability for deferred revenue, which will be amortized into rental revenue over the lives of the related leases. The decision to further restate the Company's consolidated financial statements was previously announced in our Current Reports on Form 8-K filed with the Securities and Exchange Commission on October 25, 2005 and October 31, 2005.

**Table of Contents**

To reflect the restatements of the consolidated financial statements described above and an update for discontinued operations, the Company is also re-issuing Part I, Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations ( MD&A ) and Part I, Item 3 Quantitative and Qualitative Disclosures about Market Risk that accompanied the financial statements in the Original Filing.

This Form 10-Q/A does not reflect events occurring after the filing of the Original Filing or modify or update disclosures, including the exhibits to the Original Filing, affected by subsequent events except in connection with the foregoing.

**Table of Contents**

**KILROY REALTY CORPORATION**

**QUARTERLY REPORT FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2005**

**TABLE OF CONTENTS**

	<b>Page</b>
<b><u>PART I FINANCIAL INFORMATION</u></b>	
Item 1. <b><u>FINANCIAL STATEMENTS (unaudited)</u></b>	5
<u>Consolidated Balance Sheets as of June 30, 2005 (As Restated, see Note 14) and December 31, 2004</u>	5
<u>Consolidated Statements of Operations for the Three and Six Months Ended June 30, 2005 (As Restated, see Note 14) and 2004 (As Restated, see Note 14)</u>	6
<u>Consolidated Statement of Stockholders' Equity for the Six Months Ended June 30, 2005 (As Restated, see Note 14)</u>	7
<u>Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2005 (As Restated, see Note 14) and 2004 (As Restated, see Note 14)</u>	8
<u>Notes to Consolidated Financial Statements</u>	9
Item 2. <b><u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u></b>	24
Item 3. <b><u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u></b>	47
Item 4. <b><u>CONTROLS AND PROCEDURES</u></b>	48
<b><u>PART II OTHER INFORMATION</u></b>	
Item 6. <b><u>EXHIBITS</u></b>	51
<b><u>SIGNATURES</u></b>	52

**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****KILROY REALTY CORPORATION****CONSOLIDATED BALANCE SHEETS****(unaudited, in thousands, except share data)**

	<b>June 30, 2005</b>	<b>December 31, 2004</b>
	<b>(As Restated, See Note 14)</b>	
<b><u>ASSETS</u></b>		
REAL ESTATE ASSETS (Notes 2, 3 and 4):		
Land and improvements	\$ 296,412	\$ 304,033
Buildings and improvements, net	1,450,940	1,465,285
Undeveloped land and construction in progress	130,818	93,912
	<u>1,878,170</u>	<u>1,863,230</u>
Total real estate held for investment	1,878,170	1,863,230
Accumulated depreciation and amortization	(390,491)	(372,656)
	<u>1,487,679</u>	<u>1,490,574</u>
Investment in real estate, net	1,487,679	1,490,574
Property held for sale, net	3,693	
	<u>1,491,372</u>	<u>1,490,574</u>
Total real estate assets, net	1,491,372	1,490,574
CASH AND CASH EQUIVALENTS	7,706	4,853
RESTRICTED CASH	728	332
CURRENT RECEIVABLES, NET	3,624	4,843
DEFERRED RENT RECEIVABLES, NET	51,568	46,816
DEFERRED LEASING COSTS AND OTHER RELATED INTANGIBLES, NET	48,575	50,711
DEFERRED FINANCING COSTS, NET (Note 6)	5,724	5,849
PREPAID EXPENSES AND OTHER ASSETS	6,246	5,046
	<u>1,615,543</u>	<u>1,609,024</u>
<b>TOTAL ASSETS</b>	<b>\$ 1,615,543</b>	<b>\$ 1,609,024</b>
<b><u>LIABILITIES AND STOCKHOLDERS' EQUITY</u></b>		
<b>LIABILITIES:</b>		
Secured debt (Note 5)	\$ 490,417	\$ 490,441
Unsecured senior notes	144,000	144,000
Unsecured line of credit (Note 5)	184,000	167,000
Accounts payable, accrued expenses and other liabilities (Note 8)	81,689	73,005
Accrued distributions (Note 13)	17,844	16,923
Rents received in advance, tenant security deposits and deferred revenue	36,572	37,979
	<u>954,522</u>	<u>929,348</u>
Total liabilities	954,522	929,348

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### COMMITMENTS AND CONTINGENCIES (Note 9)

#### MINORITY INTERESTS (Note 7):

7.45% Series A Cumulative Redeemable Preferred unitholders	73,638	73,638
Common unitholders of the Operating Partnership	53,148	59,491
	126,786	133,129
<b>Total minority interests</b>	<b>126,786</b>	<b>133,129</b>

#### STOCKHOLDERS EQUITY (Note 8):

Preferred stock, \$.01 par value, 21,840,000 shares authorized, none issued and outstanding		
7.45% Series A Cumulative Redeemable Preferred stock, \$.01 par value, 1,700,000 shares authorized, none issued and outstanding		
Series B Junior Participating Preferred stock, \$.01 par value, 400,000 shares authorized, none issued and outstanding		
9.25% Series D Cumulative Redeemable Preferred stock, \$.01 par value, 1,000,000 shares authorized, none issued and outstanding		
7.80% Series E Cumulative Redeemable Preferred stock, \$.01 par value, 1,610,000 shares authorized, issued and outstanding	38,425	38,425
7.50% Series F Cumulative Redeemable Preferred stock, \$.01 par value, 3,450,000 shares authorized, issued and outstanding	83,157	83,157
Common stock, \$.01 par value, 150,000,000 shares authorized, 28,899,939 and 28,548,597 shares issued and outstanding, respectively	289	286
Additional paid-in capital	522,547	515,518
Deferred compensation	(3,069)	(1,412)
Distributions in excess of earnings	(107,114)	(89,427)
	534,235	546,547
<b>Total stockholders equity</b>	<b>534,235</b>	<b>546,547</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b>	<b>\$ 1,615,543</b>	<b>\$ 1,609,024</b>

See accompanying notes to consolidated financial statements.

**Table of Contents****KILROY REALTY CORPORATION****CONSOLIDATED STATEMENTS OF OPERATIONS****(unaudited, in thousands, except share and per share data)**

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2005	2004	2005	2004
	(As Restated, see Note 14)			
<b>REVENUES (Note 10):</b>				
Rental income	\$ 53,997	\$ 48,373	\$ 107,807	\$ 95,753
Tenant reimbursements	6,169	5,062	11,920	10,386
Other property income	403	128	623	664
<b>Total revenues</b>	<b>60,569</b>	<b>53,563</b>	<b>120,350</b>	<b>106,803</b>
<b>EXPENSES (Note 10):</b>				
Property expenses	10,061	8,369	19,463	16,797
Real estate taxes	4,462	4,092	8,859	7,954
Provision for bad debts	272	385	1,405	610
Ground leases	443	332	848	662
General and administrative expenses (Note 8)	16,790	5,250	22,814	12,943
Interest expense	9,618	8,186	19,078	16,363
Depreciation and amortization	16,759	14,523	33,427	28,581
<b>Total expenses</b>	<b>58,405</b>	<b>41,137</b>	<b>105,894</b>	<b>83,910</b>
<b>OTHER INCOME AND EXPENSE</b>				
Net settlement receipts (payments) on interest rate swaps	62	(839)	(40)	(1,685)
(Loss) gain on derivative instruments	(280)	2,820	364	2,286
Interest and other income	54	78	111	385
<b>Total other (expense) income</b>	<b>(164)</b>	<b>2,059</b>	<b>435</b>	<b>986</b>
<b>INCOME FROM CONTINUING OPERATIONS BEFORE MINORITY INTERESTS</b>	<b>2,000</b>	<b>14,485</b>	<b>14,891</b>	<b>23,879</b>
<b>MINORITY INTERESTS:</b>				
Distributions on Cumulative Redeemable Preferred units	(1,397)	(2,437)	(2,794)	(4,958)
Minority interest in loss (earnings) of Operating Partnership attributable to continuing operations	233	(1,426)	(849)	(2,209)
<b>Total minority interests</b>	<b>(1,164)</b>	<b>(3,863)</b>	<b>(3,643)</b>	<b>(7,167)</b>
<b>INCOME FROM CONTINUING OPERATIONS</b>	<b>836</b>	<b>10,622</b>	<b>11,248</b>	<b>16,712</b>
<b>DISCONTINUED OPERATIONS (Note 11)</b>				
Revenues from discontinued operations	21	1,806	1,100	4,460



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Expenses from discontinued operations	(116)	(1,005)	(830)	(2,335)
Net (loss) gain on disposition of discontinued operations.		(64)	5,779	(64)
Impairment loss on property held for sale				(726)
Minority interest in loss (earnings) of Operating Partnership attributable to discontinued operations.	25	(93)	(705)	(170)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total (loss) income from discontinued operations.	(70)	644	5,344	1,165
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
NET INCOME	766	11,266	16,592	17,877
PREFERRED DIVIDENDS	(2,402)	(785)	(4,804)	(1,570)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
NET (LOSS) INCOME AVAILABLE FOR COMMON STOCKHOLDERS	\$ (1,636)	\$ 10,481	\$ 11,788	\$ 16,307
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
(Loss) income from continuing operations per common share basic (Note 12)	\$ (0.05)	\$ 0.35	\$ 0.22	\$ 0.54
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
(Loss) income from continuing operations per common share diluted (Note 12)	\$ (0.05)	\$ 0.35	\$ 0.22	\$ 0.53
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net (loss) income per common share basic (Note 12)	\$ (0.05)	\$ 0.37	\$ 0.41	\$ 0.58
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net (loss) income per common share diluted (Note 12)	\$ (0.05)	\$ 0.37	\$ 0.41	\$ 0.58
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Weighted average shares outstanding basic (Note 12)	28,739,286	28,220,130	28,647,556	28,168,405
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Weighted average shares outstanding diluted (Note 12)	28,739,286	28,361,707	28,797,606	28,332,534
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Dividends declared per common share	\$ 0.51	\$ 0.495	\$ 1.02	\$ 0.990
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

See accompanying notes to consolidated financial statements.

**Table of Contents****KILROY REALTY CORPORATION****CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY**

(unaudited, in thousands, except share and per share data)

	Common Stock						Total
	Preferred Stock	Number of Shares	Common Stock	Additional Paid-in Capital	Deferred Compensation	Distributions in Excess of Earnings	
BALANCE AT DECEMBER 31, 2004	\$ 121,582	28,548,597	\$ 286	\$ 515,518	\$ (1,412)	\$ (89,427)	\$ 546,547
Net income (As Restated, see Note 14)						16,592	16,592
Issuance of restricted stock (Note 8)		103,806	1	4,300	(2,865)		1,436
Exercise of stock options		16,666		375			375
Non-cash amortization of restricted stock					1,208		1,208
Repurchase of common stock (Note 8)		(41,379)	(1)	(1,755)			(1,756)
Redemption of common limited partnership units of the Operating Partnership (Note 7)		272,249	3	7,306			7,309
Stock option expense (Note 1)				4			4
Adjustment for minority interest (Note 1) (As Restated, see Note 14)				(3,201)			(3,201)
Preferred dividends						(4,804)	(4,804)
Common dividends declared (\$1.020 per share)						(29,475)	(29,475)
<b>BALANCE AT JUNE 30, 2005 (As Restated, see Note 14)</b>	<b>\$ 121,582</b>	<b>28,899,939</b>	<b>\$ 289</b>	<b>\$ 522,547</b>	<b>\$ (3,069)</b>	<b>\$ (107,114)</b>	<b>\$ 534,235</b>

See accompanying notes to consolidated financial statements.

**Table of Contents****KILROY REALTY CORPORATION****CONSOLIDATED STATEMENTS OF CASH FLOWS****(unaudited, in thousands)**

	<b>Six Months Ended</b>	
	<b>June 30,</b>	
	<b>2005</b>	<b>2004</b>
	<b>(As Restated, see Note 14)</b>	
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 16,592	\$ 17,877
Adjustments to reconcile net income to net cash provided by operating activities (including discontinued operations):		
Depreciation and amortization of buildings and improvements and leasing costs	33,383	29,105
Net (gain) loss on disposition of operating properties	(5,779)	64
Impairment loss on property held for sale		726
Distributions on Cumulative Redeemable Preferred units	2,794	4,958
Minority interest in earnings of Operating Partnership	1,554	2,379
Non-cash amortization of restricted stock grants	1,827	1,733
Non-cash amortization of deferred financing costs	701	938
Non-cash amortization of deferred revenue for reimbursement of tenant improvements	(1,078)	(918)
(Gain) loss on derivative instruments	(364)	(2,286)
Net settlement payments on interest rate swaps	40	1,685
Amortization of above/below market rents, net	(606)	(12)
Increase in provision for uncollectible tenant receivables	630	38
Increase in provision for uncollectible deferred rent receivables	772	617
Depreciation of furniture, fixtures and equipment	437	454
Other	10	(12)
Changes in assets and liabilities:		
Current receivables	588	838
Deferred rent receivables	(7,093)	(5,300)
Deferred leasing costs	(536)	(856)
Prepaid expenses and other assets	(1,850)	107
Accounts payable, accrued expenses and other liabilities	11,049	(33)
Rents received in advance, tenant security deposits and deferred revenue	(210)	(279)
<b>Net cash provided by operating activities</b>	<b>52,861</b>	<b>51,823</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Expenditures for operating properties	(10,981)	(12,752)
Expenditures for development and redevelopment projects and undeveloped land	(20,327)	(14,012)
Acquisition of an operating property and undeveloped land	(31,328)	
Net proceeds received from dispositions of operating properties	37,859	18,723
(Increase) decrease in restricted cash	(396)	1,206
Net cash settlement payments on interest rate swaps	(125)	(1,699)
<b>Net cash used in investing activities</b>	<b>(25,298)</b>	<b>(8,534)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from issuance of secured debt	35,500	115,218
Net borrowings (repayments) on unsecured line of credit	17,000	(95,000)
Principal payments on secured debt	(35,524)	(26,460)

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Distributions paid to common stockholders and common unitholders	(32,739)	(32,095)
Repurchase of common stock (Note 8)	(1,756)	(1,275)
Financing costs	(360)	(384)
Proceeds from exercise of stock options	375	793
Distributions paid to preferred stockholders and preferred unitholders	(7,206)	(6,534)
	<u>          </u>	<u>          </u>
Net cash used in financing activities	(24,710)	(45,737)
	<u>          </u>	<u>          </u>
Net increase (decrease) in cash and cash equivalents	2,853	(2,448)
Cash and cash equivalents, beginning of period	4,853	9,892
	<u>          </u>	<u>          </u>
Cash and cash equivalents, end of period	\$ 7,706	\$ 7,444
	<u>          </u>	<u>          </u>
<b>SUPPLEMENTAL CASH FLOW INFORMATION:</b>		
Cash paid for interest, net of capitalized interest of \$4,016 and \$3,381 at June 30, 2005 and 2004, respectively	\$ 17,934	\$ 15,027
	<u>          </u>	<u>          </u>
<b>NON-CASH TRANSACTIONS:</b>		
Accrual of distributions payable to common stockholders and common unitholders (Note 13)	\$ 16,635	\$ 16,077
	<u>          </u>	<u>          </u>
Receipt of stock in connection with a lease termination fee		\$ 494
		<u>          </u>

See accompanying notes to consolidated financial statements.

**Table of Contents**

**KILROY REALTY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Three and Six Months Ended June 30, 2005 and 2004**

**(unaudited)**

**1. Organization and Basis of Presentation**

*Organization*

Kilroy Realty Corporation (the "Company") owns, operates and develops office and industrial real estate, primarily in Southern California. The Company operates as a self-administered real estate investment trust ("REIT"). As of June 30, 2005, the Company's stabilized portfolio of operating properties consisted of 83 office buildings (the "Office Properties") and 47 industrial buildings (the "Industrial Properties"), which encompassed an aggregate of approximately 7.6 million and 4.4 million rentable square feet, respectively, and was 95.2% occupied. The Company's stabilized portfolio of operating properties consists of all of the Office Properties and Industrial Properties and excludes properties currently under construction, lease-up properties and properties classified as held for sale.

The Company defines lease-up properties as properties recently developed or redeveloped by the Company that have not yet reached 95% occupancy and are within one year following substantial completion. Lease-up properties are reclassified to land and improvements and building and improvements from construction in progress on the consolidated balance sheets upon building shell completion. As of June 30, 2005, the Company had one redevelopment property encompassing approximately 241,600 rentable square feet, which was in the lease-up phase. The Company also had two development properties under construction, which when completed are expected to encompass approximately 103,300 rentable square feet. As of June 30, 2005, the Company had one property held for sale encompassing approximately 113,800 rentable square feet.

The Company owns its interests in all of its Office Properties and Industrial Properties through Kilroy Realty, L.P. (the "Operating Partnership") and Kilroy Realty Finance Partnership, L.P. (the "Finance Partnership") and conducts substantially all of its operations through the Operating Partnership. The Company owned an 88.6% general partnership interest in the Operating Partnership as of June 30, 2005. Kilroy Realty Finance, Inc., a wholly-owned subsidiary of the Company, is the sole general partner of the Finance Partnership and owns a 1.0% general partnership interest in the Finance Partnership. The Operating Partnership owns the remaining 99.0% limited partnership interest of the Finance Partnership. The Company conducts substantially all of its development services through Kilroy Services, LLC ("KSLLC"), which is a wholly-owned subsidiary of the Operating Partnership. Unless otherwise indicated, all references to the Company include the Operating Partnership, the Finance Partnership, KSLLC and all wholly-owned subsidiaries of the Company.

*Basis of Presentation*

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The consolidated financial statements of the Company include the consolidated financial position and results of operations of the Company, the Operating Partnership, the Finance Partnership, KSLLC and all wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in the consolidated financial statements.

As of June 30, 2005, the Company also consolidated one variable interest entity ( VIE ). The Company was deemed to be the primary beneficiary of this entity in accordance with FASB Interpretation No. 46R ( FIN 46R ). In May 2005, the Company entered into an agreement with this VIE to facilitate a 1031 tax-deferred property exchange. Under the terms of the agreement, the Company is obligated to purchase the undeveloped land held by the VIE within 180 days of the sale of a property to complete the exchange. The Company retains all rights to appreciation and all exposure to depreciation in the value of the property during the period it is held at the VIE. The impact of consolidating the VIE is to increase the Company s total undeveloped land and construction in progress balance by approximately \$24 million at June 30, 2005. The acquisition of the undeveloped land was funded with borrowings under the Company s Credit Facility (defined in Note 5).

**Table of Contents**

**KILROY REALTY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Net income after preferred distributions and preferred dividends is allocated to the common limited partners of the Operating Partnership ( Minority Interest of the Operating Partnership ) based on their ownership percentage of the Operating Partnership. The common limited partner ownership percentage is determined by dividing the number of common units held by the Minority Interest of the Operating Partnership by the total common units outstanding. The issuance of additional shares of common stock or common units results in changes to the Minority Interest of the Operating Partnership percentage as well as the total net assets of the Company. As a result, all capital transactions result in an allocation between stockholders' equity and the minority interest held by common unitholders of the Operating Partnership in the accompanying consolidated balance sheets to account for the change in the Minority Interest of the Operating Partnership ownership percentage as well as the change in total net assets of the Company.

The accompanying interim financial statements have been prepared by the Company's management in accordance with accounting principles generally accepted in the United States of America ( GAAP ) and in conjunction with the rules and regulations of the Securities and Exchange Commission ( SEC ). Certain information and footnote disclosures required for annual financial statements have been condensed or excluded pursuant to SEC rules and regulations. Accordingly, the interim financial statements do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, the accompanying interim financial statements reflect all adjustments of a normal and recurring nature which are considered necessary for a fair presentation of the results for the interim periods presented. However, the results of operations for the interim periods are not necessarily indicative of the results that may be expected for the year ending December 31, 2005.

*Reclassifications*

Certain prior period amounts have been reclassified to conform to the current period's presentation. The Company reclassified the change in restricted cash in the consolidated statements of cash flows from a financing activity to an investing activity for the six months ended June 30, 2004.

*Recent Accounting Pronouncements*

In December 2004, the FASB issued Statement 123 (revised), Share-Based Payment ( FAS 123(R) ). FAS 123(R) requires that all share-based payments to employees, including grants of employee stock options, be recognized in the income statement based on their fair values. The new standard will be effective as of the beginning of the first fiscal year beginning after June 15, 2005. The adoption of this statement is not expected to have a material effect on the Company's results of operations or financial condition.

In March 2005, the FASB issued Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations ( FIN 47 ). FIN 47 clarifies guidance provided in FASB Statement No. 143, Accounting for Asset Retirement Obligations. The term asset retirement obligation refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. Entities are required to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability's fair value can be reasonably estimated. FIN 47 will be effective as of the end of the first fiscal year

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ending after December 15, 2005. The adoption of the interpretation is not expected to have a material effect on the Company's results of operations or financial condition.

### *Stock Option Accounting*

Effective January 1, 2002, the Company voluntarily adopted the fair value recognition provisions of SFAS 123, Accounting for Stock-Based Compensation ( SFAS 123 ) prospectively, for all employee stock option



**Table of Contents****KILROY REALTY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

awards granted or settled after January 1, 2002. Under the fair value recognition provisions of SFAS 123, total compensation expense related to stock options is determined using the fair value of the stock options on the date of grant. Total compensation expense is then recognized on a straight-line basis over the option vesting period. All of the Company's outstanding stock options were fully vested as of February 2005.

Prior to 2002, the Company accounted for stock options issued under the recognition and measurement provisions of APB Opinion 25

Accounting for Stock Issued to Employees and related interpretations. The following table illustrates the effect on net income and earnings per share if the fair value based method had been applied to all outstanding and unvested awards in each period.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
	(in 000s, except per share amounts)			
Net (loss) income available for common stockholders, as reported	\$ (1,636)	\$ 10,481	\$ 11,788	\$ 16,307
Add: Stock option expense included in reported net income		7	4	13
Deduct: Total stock option expense determined under fair value recognition method for all awards		(7)	(4)	(17)
Pro forma net (loss) income available for common stockholders.	\$ (1,636)	\$ 10,481	\$ 11,788	\$ 16,303
Net (loss) income per common share:				
Basic as reported	\$ (0.05)	\$ 0.37	\$ 0.41	\$ 0.58
Basic pro forma	\$ (0.05)	\$ 0.37	\$ 0.41	\$ 0.58
Diluted as reported	\$ (0.05)	\$ 0.37	\$ 0.41	\$ 0.58
Diluted pro forma	\$ (0.05)	\$ 0.37	\$ 0.41	\$ 0.58

**2. Acquisitions**

In May 2005, the Company acquired an office property in Brea, California from an unaffiliated third party for a purchase price of \$7.3 million. The building, which encompasses approximately 45,900 rentable square feet, was 100% leased as of the acquisition date. In June 2005, the Company acquired approximately 11.3 acres of undeveloped land located in San Diego County, California from an unaffiliated third party for approximately \$24.0 million. Both of these acquisitions were funded with borrowings under the Company's Credit Facility (defined in Note 5).



**Table of Contents****KILROY REALTY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****3. Dispositions and Property Held for Sale***Dispositions*

During the six months ended June 30, 2005, the Company sold the following properties:

<u>Address / City</u>	<u>Property Type</u>	<u>Month of Disposition</u>	<u>Number of Buildings</u>	<u>Rentable Square Feet</u>
2501 Pullman/1700 Carnegie Santa Ana, CA 525 North Brand	Office	March	2	128,266
Glendale, CA 5115 North 27th Avenue	Office	March	1	46,043
Phoenix, AZ	Industrial	March	1	130,877
<b>Total</b>			<b>4</b>	<b>305,186</b>

These properties were sold through a portfolio transaction for an aggregate gross sales price of \$38.7 million. The Company recorded a net gain of approximately \$5.8 million in connection with the disposition. The Company used the net cash proceeds from the sale of these properties to fund its development program and to repay borrowings under the Credit Facility (defined in Note 5). The net income and the net gain on disposition for these properties have been included in discontinued operations for the three and six months ended June 30, 2005 and 2004 (see Note 11).

*Property Held for Sale*

The Company identified the following property as held for sale as of June 30, 2005. The property was subsequently sold in July 2005 to an unrelated third party for a gross sales price of \$22.5 million, which consisted of an \$11.25 million cash payment and an \$11.25 million note receivable from the buyer. As partial consideration for the sale, the Company will also participate in certain future net profits from the operation or sale of the property as set forth in a profit participation agreement, without risk of loss or further obligations. The contingent future profits

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will be recognized in the period they are realized. The Company will record a net gain of approximately \$18.0 million in connection with the disposition. The property was not occupied as of June 30, 2005.

<u>Address / City</u>	<u>Property Type</u>	<u>Number of Buildings</u>	<u>Rentable Square Feet</u>
2260 E. El Segundo Blvd El Segundo, CA	Industrial	1	113,820
<b>Total</b>		<b>1</b>	<b>113,820</b>

The following table summarizes the major classes of assets attributable to the property held for sale as of June 30, 2005. There were no outstanding liabilities associated with this property as of June 30, 2005.

	<b>(in thousands)</b>
<b>ASSETS:</b>	
Land and improvements	\$ 1,703
Buildings and improvements	6,273
Accumulated depreciation	(4,283)
<b>Property held for sale, net</b>	<b>\$ 3,693</b>

**Table of Contents****KILROY REALTY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****4. Redevelopment Projects***Stabilized Redevelopment Project*

During the six months ended June 30, 2005, the Company added the following redevelopment project to the Company's stabilized portfolio:

<u>Address / Submarket / City</u>	<u>Property Type</u>	<u>Completion Date</u>	<u>Stabilization Date</u>	<u>Number of Buildings</u>	<u>Rentable Square Feet</u>
5717 Pacific Center Blvd. Sorrento Mesa San Diego, CA	Office	Q1 2004	Q1 2005	1	68,000

**5. Unsecured and Secured Debt***Unsecured Line of Credit*

As of June 30, 2005, the Company had borrowings of \$184.0 million outstanding under its revolving unsecured line of credit (the Credit Facility) and availability of approximately \$241.0 million. The Credit Facility bears interest at an annual rate between LIBOR plus 1.00% and LIBOR plus 1.70% depending upon the Company's leverage ratio at the time of borrowing (4.43% at June 30, 2005), and matures in October 2007 with an option to extend the maturity for one year. The fee for unused funds ranges from an annual rate of 0.20% to 0.30% depending on the Company's leverage ratio. The Company expects to use the Credit Facility to finance development and redevelopment expenditures, to fund potential acquisitions and for other general corporate uses.

*Secured Debt*

In June 2005, the Company borrowed \$35.5 million under a mortgage loan that is secured by eleven properties, requires interest-only payments based on a variable annual interest rate of LIBOR plus 0.90% (4.23% at June 30, 2005) and matures in July 2008. The loan has two one-year extension options and allows for partial recourse, up to 25% of the principal balance of the loan. The Company used a portion of the proceeds to

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repay an outstanding mortgage loan with a principal balance of \$29 million that was scheduled to mature in December 2005. The remainder of the proceeds was used primarily to repay borrowings under the Credit Facility.

### *Debt Covenants and Restrictions*

The Credit Facility, the unsecured senior notes and certain other secured debt arrangements contain covenants and restrictions requiring the Company to meet certain financial ratios and reporting requirements, including a maximum total debt to total assets ratio, a maximum total secured debt to total assets ratio, a maximum dividend payout ratio, minimum debt service coverage and fixed charge coverage ratios, minimum consolidated tangible net worth and a limit of development activities as compared to total assets. The Company was in compliance with all of its debt covenants at June 30, 2005.

### *Capitalized Interest and Loan Fees*

Total interest and loan fees capitalized for the three months ended June 30, 2005 and 2004 were \$2.2 million and \$1.8 million, respectively. Total interest and loan fees capitalized for the six months ended June 30, 2005 and 2004 were \$4.2 million and \$3.7 million, respectively.

**Table of Contents****KILROY REALTY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****6. Derivative Financial Instruments**

The following table sets forth the terms and fair market value of the Company's derivative financial instruments at June 30, 2005:

<u>Type of Instrument</u>	<u>Notional Amount</u>	<u>Index</u>	<u>Rate</u>	<u>Maturity Date</u>	<u>Fair Market Value</u>
	(in thousands)				(in thousands)
Interest rate swap	\$ 50,000	LIBOR	2.57%	November 2005	\$ 182
Interest rate swap	25,000	LIBOR	2.98%	December 2006	311
Interest rate swap	25,000	LIBOR	2.98%	December 2006	311
Total included in deferred financing costs					<u>\$ 804</u>

In January 2005, the Company's interest-rate swap agreement to fix LIBOR on \$50 million of its variable-rate debt at 4.46% expired.

**7. Minority Interests**

Minority interests represent the common and preferred limited partnership interests in the Operating Partnership. The Company owned an 88.6% and 87.4% general partnership interest in the Operating Partnership as of June 30, 2005 and 2004, respectively.

During the six months ended June 30, 2005, 272,249 common limited partnership units of the Operating Partnership were redeemed for shares of the Company's common stock on a one-for-one basis. Neither the Company nor the Operating Partnership received any proceeds from the issuance of the common stock in exchange for common limited partnership units.

**8. Stockholders' Equity and Employee Incentive Plans**

In February 2005, the Company's Compensation Committee granted an aggregate of 101,112 restricted shares of common stock to certain executive officers and key employees. Compensation expense for the restricted shares is calculated based on the closing price per share of \$41.35 on the February 23, 2005 grant date and is amortized on a straight-line basis over the performance and vesting periods. Of the shares

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granted, 18,139 vest at the end of a one-year period, 61,812 vest in equal annual installments over a two-year period and 21,161 vest in equal annual installments over a five-year period. The Company recorded approximately \$0.3 million and \$0.4 million in compensation expense related to these restricted stock grants during the three months ended June 30, 2005 and 2004, respectively and \$0.6 million and \$0.7 million during the six months ended June 30, 2005 and 2004, respectively.

In May 2005, the Company's Compensation Committee granted an aggregate of 2,694 restricted shares of the Company's common stock to non-employee board members as part of the board members' annual compensation plan. Of the shares granted, 1,350 vest at the end of a one-year period and 1,344 vest at the end of a two-year period. Compensation expense for the restricted shares is calculated based on the closing per-share price of \$44.56 on the May 17, 2005 grant date and is being amortized on a straight-line basis over the two-year vesting period. The Company recorded approximately \$7,000 related to these restricted stock grants during the three months ended June 30, 2005.

In March 2003, the Company's Compensation Committee approved a special long-term compensation program for the Company's executive officers. The program provides for cash compensation to be earned at December 31, 2005 if the Company attains certain performance measures based on annualized total stockholder



**Table of Contents**

**KILROY REALTY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

returns on an absolute and relative basis. The amount payable for the absolute component is based upon the amount by which the annualized total return to stockholders over the period exceeds 10%. The targets for the relative component require the Company to obtain an annualized total return to stockholders that is at or above the 70th percentile of annualized total return to stockholders achieved by members of a pre-defined peer group during the same three-year period, and includes additional incentives for annualized total return to stockholders that is at or above the 80th percentile. Compensation expense under this program is accounted for using variable plan accounting. The Company estimates the amount to be paid based on the average closing share price of the Company's common stock as reported on the New York Stock Exchange ( NYSE ) for the last ten days of the period, and records compensation expense equal to that portion of the total compensation applicable to the portion of the performance period that has elapsed through the end of the period. Under the absolute portion of the plan, for every \$1 change in the Company's ten-day average closing stock price, the total payable over the three-year term of the plan changes by approximately \$1.7 million. During the three months ended June 30, 2005 and 2004, the Company accrued approximately \$12.5 million and \$1.3 million, respectively, and during the six months ended June 30, 2005 and 2004, the Company accrued \$14.2 million and \$5.0 million, respectively, of compensation expense related to this plan, which is included in general and administrative expenses. The total amount accrued relating to the plan was \$38.5 million as of June 30, 2005, which is included in accounts payable, accrued expenses and other liabilities.

During the six months ended June 30, 2005, the Company accepted the return, at the current quoted market price, of 41,379 shares of its common stock from certain key employees in accordance with the provisions of its incentive stock plan to satisfy minimum statutory tax-withholding requirements related to restricted shares that vested during this period.

**9. Commitments and Contingencies**

In January 2005, the Company paid \$1.8 million pursuant to a court approved settlement agreement related to a lease termination that occurred in 2001. The amount was previously recorded as a charge to other property income during the third quarter of 2004.

**Table of Contents****KILROY REALTY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****10. Segment Disclosure**

The Company's reportable segments consist of the two types of commercial real estate properties for which management internally evaluates operating performance and financial results: Office Properties and Industrial Properties. The Company also has certain corporate level activities, including legal, accounting, finance and management information systems, which are not considered separate operating segments.

The Company evaluates the performance of its segments based upon Net Operating Income. Net Operating Income is defined as operating revenues (rental income, tenant reimbursements and other property income) less property and related expenses (property expenses, real estate taxes, ground leases and provision for bad debts) and does not include interest and other income, interest expense, depreciation and amortization and general and administrative expenses. There is no intersegment activity.

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2005	2004	2005	2004
	(in thousands)			
<b>Office Properties:</b>				
Operating revenues(1)	\$ 51,507	\$ 44,759	\$ 102,200	\$ 89,288
Property and related expenses	13,660	11,811	27,663	23,442
Net Operating Income, as defined	37,847	32,948	74,537	65,846
<b>Industrial Properties:</b>				
Operating revenues(1)	9,062	8,804	18,150	17,515
Property and related expenses	1,578	1,367	2,912	2,581
Net Operating Income, as defined	7,484	7,437	15,238	14,934
<b>Total Reportable Segments:</b>				
Operating revenues(1)	60,569	53,563	120,350	106,803
Property and related expenses	15,238	13,178	30,575	26,023
Net Operating Income, as defined	45,331	40,385	89,775	80,780
<b>Reconciliation to Consolidated Net Income:</b>				
Total Net Operating Income, as defined, for reportable segments	45,331	40,385	89,775	80,780
Unallocated other income (expense):				
Total other (expense) income	(164)	2,059	435	986
Other unallocated expenses:				
General and administrative expenses	16,790	5,250	22,814	12,943

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Interest expense	9,618	8,186	19,078	16,363
Depreciation and amortization	16,759	14,523	33,427	28,581
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Income from continuing operations before minority interests and preferred dividends	2,000	14,485	14,891	23,879
Minority interests attributable to continuing operations	(1,164)	(3,863)	(3,643)	(7,167)
(Loss) income from discontinued operations	(70)	644	5,344	1,165
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net income	766	11,266	16,592	17,877
Preferred dividends	(2,402)	(785)	(4,804)	(1,570)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net (loss) income available to common stockholders	\$ (1,636)	\$ 10,481	\$ 11,788	\$ 16,307
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

(1) All operating revenues are comprised of amounts received from third-party tenants.

**Table of Contents****KILROY REALTY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****11. Discontinued Operations**

In accordance with SFAS 144 Accounting for the Impairment or Disposal of Long-Lived Assets, the net income or loss and the net gain or loss on dispositions of operating properties sold and classified as held for sale are reflected in the consolidated statements of operations as discontinued operations for all periods presented. For the three and six months ended June 30, 2005 and 2004, discontinued operations included the net income or loss and the net gain on sale of the four buildings sold during the six months ended June 30, 2005 and the one property classified as held for sale at June 30, 2005 (see Note 3). For the three and six months ended June 30, 2004, discontinued operations also included the net income, the impairment loss and net gain or loss on sale of the two properties sold in 2004. The following table summarizes the income and expense components that comprise discontinued operations for the three and six months ended June 30, 2005 and 2004:

	Three Months		Six Months	
	Ended		Ended	
	June 30,		June 30,	
	2005	2004	2005	2004
(in thousands)				
<b>REVENUES:</b>				
Rental income	\$	\$ 1,633	\$ 931	\$ 3,598
Tenant reimbursements	1	173	138	377
Other property income	20		31	485
<b>Total revenues</b>	<b>21</b>	<b>1,806</b>	<b>1,100</b>	<b>4,460</b>
<b>EXPENSES:</b>				
Property expenses	46	394	279	914
Real estate taxes	23	188	161	398
Provision for bad debts		6	(3)	45
Depreciation and amortization	47	417	393	978
<b>Total expenses</b>	<b>116</b>	<b>1,005</b>	<b>830</b>	<b>2,335</b>
(Loss) income from discontinued operations before minority interests	(95)	801	270	2,125
Net (loss) gain on disposition of discontinued operations		(64)	5,779	(64)
Impairment loss on property held for sale				(726)
Minority interest in loss (earnings) of Operating Partnership attributable to discontinued operations	25	(93)	(705)	(170)
<b>Total (loss) income from discontinued operations</b>	<b>\$ (70)</b>	<b>\$ 644</b>	<b>\$ 5,344</b>	<b>\$ 1,165</b>



**Table of Contents****KILROY REALTY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****12. Earnings (Loss) Per Share**

Basic earnings (loss) per share is computed by dividing net income or loss by the weighted-average number of common shares outstanding for the period. Diluted earnings (loss) per share is computed by dividing net income or loss by the sum of the weighted-average number of common shares outstanding for the period plus the number of common shares issuable assuming the exercise of all dilutive securities. The Company does not consider common units of the Operating Partnership to be dilutive since any issuance of shares of common stock upon the redemption of the common units would be on a one-for-one basis and would not have any effect on diluted earnings per share. The following table reconciles the numerator and denominator of the basic and diluted per-share computations for net income or loss.

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2005	2004	2005	2004
(in thousands, except share and per share amounts)				
<b>Numerator:</b>				
Income from continuing operations	\$ 836	\$ 10,622	\$ 11,248	\$ 16,712
Preferred dividends	(2,402)	(785)	(4,804)	(1,570)
(Loss) income from continuing operations available for common stockholders	(1,566)	9,837	6,444	15,142
Discontinued operations	(70)	644	5,344	1,165
Net (loss) income available for common stockholders numerator for basic and diluted earnings per share	\$ (1,636)	\$ 10,481	\$ 11,788	\$ 16,307
<b>Denominator:</b>				
Basic weighted-average shares outstanding	28,739,286	28,220,130	28,647,556	28,168,405
Effect of dilutive securities-stock options and restricted stock		141,577	150,050	164,129
Diluted weighted-average shares and common share equivalents outstanding	28,739,286	28,361,707	28,797,606	28,332,534
<b>Basic earnings (loss) per share:</b>				
(Loss) income from continuing operations available for common stockholders	\$ (0.05)	\$ 0.35	\$ 0.22	\$ 0.54
Discontinued operations		0.02	0.19	0.04
Net (loss) income available for common stockholders	\$ (0.05)	\$ 0.37	\$ 0.41	\$ 0.58

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<b>Diluted earnings (loss) per share:</b>				
(Loss) income from continuing operations available for common stockholders	\$ (0.05)	\$ 0.35	\$ 0.22	\$ 0.53
Discontinued operations		0.02	0.19	0.05
<b>Net (loss) income available for common stockholders</b>	<b>\$ (0.05)</b>	<b>\$ 0.37</b>	<b>\$ 0.41</b>	<b>\$ 0.58</b>

For the three months ended June 30, 2005, the effect of the assumed exercise of the 102,565 outstanding stock options and the effect of the 156,738 unvested shares of restricted stock were not included in the earnings per share calculation as their effect is antidilutive to the loss from continuing operations available for common stockholders.

**Table of Contents**

**KILROY REALTY CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**13. Subsequent Events**

On July 15, 2005, aggregate distributions of approximately \$16.6 million were paid to common stockholders and common unitholders of record on June 30, 2005.

On July 22, 2005, the Company sold an industrial property that was previously classified as held for sale as of June 30, 2005 (see Note 3).

**14. Restatements**

*Derivative Instruments*

Subsequent to the issuance of the Company's interim consolidated financial statements for the three and six months ended June 30, 2005, the Company determined that its hedge designation memos for six interest rate swap and two interest rate cap agreements entered into by the Company in 2000 and 2002 do not meet the technical requirements to qualify for hedge accounting treatment in accordance with Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133). Prior to entering into each of these agreements, the Company engaged an independent consulting firm specializing in derivatives to advise the Company with respect to derivatives and hedging matters. The Company consulted closely with the independent derivatives specialist during its preparation of the formal designation of the instruments to ensure that each of the instruments qualified for hedge accounting treatment under SFAS 133 and the related accounting guidance. Although both the Company and the independent derivatives specialist believed the designation documentation met the requirements under SFAS 133 at the time the derivative transactions were entered into, the Company has subsequently determined that the designation documentation does not meet the technical requirements under SFAS 133 to qualify for hedge accounting treatment. As a result, the Company has restated its consolidated financial statements to mark all of these instruments to market and to recognize the impact of this mark to market adjustment in the statement of operations for each period, rather than through other comprehensive income.

*Leasehold Improvements Paid by Tenants*

The Company restated its consolidated financial statements to record a capital asset and related depreciation for leasehold improvements constructed by the Company that are reimbursed by tenants, with the a corresponding liability for deferred revenue, which will be amortized into rental revenue over the lives of the related leases.

*Income from Continuing Operations per Common Share*



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Subsequent to the issuance of the Company's interim consolidated financial statements for the three and six months ended June 30, 2004, the Company's management determined that it incorrectly computed income from continuing operations per common share by not reflecting the impact of preferred stock dividends paid and accrued in respect of the Company's preferred stock in accordance with Statement of Financial Accounting Standards No. 128, Earnings per Share. As a result, Income from continuing operations per common share - basic and diluted have been restated from the amounts previously reported.

### *Cash Flow Reclassifications*

Also subsequent to the issuance of the Company's interim consolidated financial statements for the three and six months ended June 30, 2004, the Company's management concluded that it had been incorrectly classifying two items on the consolidated statements of cash flows. First, distributions to cumulative redeemable

**Table of Contents****KILROY REALTY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

preferred unitholders were included in the Company's consolidated statements of cash flows as an operating activity when, in accordance with Statement of Financial Accounting Standards No. 95 Statement of Cash Flows, distributions paid to cumulative redeemable preferred unitholders should have been classified as a financing activity. Second, capital expenditures for operating properties, development and redevelopment projects and undeveloped land were reflected on an accrual basis of accounting rather than the cash paid for such expenditures in investing activities in the statements of cash flows. The adjustment to reflect these expenditures on a cash basis in investing activities for each period is offset by an adjustment for the same amount in cash flows from operating activities to appropriately reflect the associated increases and decreases in accounts payable, accrued expenses and other liabilities. As a result, the net cash provided by (used in) operating activities, investing activities and financing activities for the six months ended June 30, 2004 included in the consolidated statements of cash flows have been restated from the amounts previously reported. In addition, as disclosed in Note 1 the Company reclassified the change in restricted cash of \$1.2 million in the consolidated statements of cash flows from a financing activity to an investing activity. These reclassifications do not affect the total net change in cash and cash equivalents and have no impact on the Company's consolidated balance sheets, consolidated statements of operations and consolidated statement of stockholders' equity.

The Company also determined that certain immaterial costs that were previously capitalized and depreciated in subsequent periods should have been expensed. The restated financial statements include an adjustment for these amounts. The following tables summarize the effects of the above mentioned changes on the Company's consolidated financial statements:

**Consolidated Balance Sheet**

	June 30, 2005		
	As Previously Reported	Restatement	As Restated
	(in thousands)		
<b>ASSETS</b>			
Buildings and improvements, net	\$ 1,431,039	\$ 19,901	\$ 1,450,940
Undeveloped land and construction in progress	133,466	(2,648)	130,818
Accumulated depreciation and amortization	(382,687)	(7,804)	(390,491)
Deferred leasing costs and other related intangibles, net	49,073	(498)	48,575
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>			
Rents received in advance, tenant security deposits and deferred revenue	20,734	15,838	36,572
Minority Interests: Common unitholders of the Operating partnership	53,934	(786)	53,148
Additional paid-in capital	522,321	226	522,547
Distributions in excess of earnings	(101,591)	(5,523)	(107,114)
Accumulated net other comprehensive income	804	(804)	

**Table of Contents****KILROY REALTY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Consolidated Statements of Operations*

	<b>Three Months Ended June 30, 2005</b>		
	<b>As Previously Reported</b>	<b>Restatement</b>	<b>As Restated</b>
<b>(in thousands, except per share amounts)</b>			
<b>REVENUES:</b>			
Rental income	\$ 53,461	\$ 536	\$ 53,997
<b>EXPENSES:</b>			
Interest expense	9,568	50	9,618
Depreciation and amortization	16,294	465	16,759
<b>OTHER INCOME AND EXPENSE:</b>			
Net settlement receipts on interest rate swaps		62	62
Loss on derivative instruments		(280)	(280)
<b>INCOME FROM CONTINUING OPERATIONS BEFORE MINORITY INTERESTS</b>	<b>2,197</b>	<b>(197)</b>	<b>2,000</b>
<b>MINORITY INTERESTS:</b>			
Minority interest in loss (earnings) of Operating Partnership attributable to continuing operations	206	27	233
Income from continuing operations	1,006	(170)	836
Net income	936	(170)	766
Net loss available to common stockholders	(1,466)	(170)	(1,636)
Loss from continuing operations per common share basic	\$ (0.05)	\$	\$ (0.05)
Loss from continuing operations per common share diluted	\$ (0.05)	\$	\$ (0.05)
Net loss per common share basic	\$ (0.05)	\$ (0.01)	\$ (0.06)
Net loss per common share diluted	\$ (0.05)	\$ (0.01)	\$ (0.06)

	<b>Three Months Ended June 30, 2004</b>			
	<b>As Previously Reported</b>	<b>Restatement</b>	<b>Reclass: Subsequent Dispositions<sup>(1)</sup></b>	<b>As Restated</b>
<b>(in thousands, except per share amounts)</b>				
<b>REVENUES:</b>				
Rental income	\$ 49,151	\$ 448	\$ (1,226)	\$ 48,373
<b>EXPENSES:</b>				
Interest expense	9,148	(962)		8,186
Depreciation and amortization	14,558	383	(418)	14,523
<b>OTHER INCOME AND EXPENSE:</b>				
Net settlement payments on interest rate swaps		(839)		(839)
Gain on derivative instruments		2,820		2,820
<b>INCOME FROM CONTINUING OPERATIONS BEFORE MINORITY INTERESTS</b>	<b>11,981</b>	<b>3,008</b>	<b>(504)</b>	<b>14,485</b>

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MINORITY INTERESTS:

Minority interest in (earnings) loss of Operating Partnership attributable to continuing operations	(1,108)	(381)	63	(1,426)
Income from continuing operations	8,436	2,627	(441)	10,622
Net income	8,639	2,627		11,266
Net income available to common stockholders	7,854	2,627		10,481
Income from continuing operations per common share basic	\$ 0.30	\$ 0.06	\$ (0.01)	\$ 0.35
Income from continuing operations per common share diluted	\$ 0.30	\$ 0.06	\$ (0.01)	\$ 0.35
Net income per common share basic	\$ 0.28	\$ 0.09	\$	\$ 0.37
Net income per common share diluted	\$ 0.28	\$ 0.09	\$	\$ 0.37

(1) Includes the discontinued operations that have resulted from the disposition of the five operating properties that were sold subsequent to June 30, 2004. The table above does not reflect all line items in the consolidated statements of operations that were impacted by the reclassification of subsequent dispositions.

**Table of Contents****KILROY REALTY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	Six Months Ended June 30, 2005		
	As Previously Reported	Restatement	As Restated
	(in thousands except per share amounts)		
<b>REVENUES:</b>			
Rental income	\$ 106,729	\$ 1,078	\$ 107,807
<b>EXPENSES:</b>			
Interest expense	19,190	(112)	19,078
Depreciation and amortization	32,490	937	33,427
<b>OTHER INCOME AND EXPENSE:</b>			
Net settlement payments on interest rate swaps		(40)	(40)
Gain on derivative instruments		364	364
<b>INCOME FROM CONTINUING OPERATIONS BEFORE MINORITY INTERESTS</b>	<b>14,314</b>	<b>577</b>	<b>14,891</b>
<b>MINORITY INTERESTS:</b>			
Minority interest in earnings of Operating Partnership attributable to continuing operations	(782)	(67)	(849)
Income from continuing operations	10,738	510	11,248
Net income	16,082	510	16,592
Net income available to common stockholders	11,278	510	11,788
Income from continuing operations per common share basic	\$ 0.21	\$ 0.01	\$ 0.22
Income from continuing operations per common share diluted	\$ 0.21	\$ 0.01	\$ 0.22
Net income per common share basic	\$ 0.39	\$ 0.02	\$ 0.41
Net income per common share diluted	\$ 0.39	\$ 0.02	\$ 0.41

	Six Months Ended June 30, 2004			
	As Previously Reported	Restatement	Reclass: Subsequent Dispositions <sup>(1)</sup>	As Restated
	(in thousands except per share amounts)			
<b>REVENUES:</b>				
Rental income	\$ 97,226	\$ 918	\$ (2,391)	\$ 95,753
<b>EXPENSES:</b>				
Interest expense	18,358	(1,995)		16,363
Depreciation and amortization	28,601	790	(810)	28,581
<b>OTHER INCOME AND EXPENSE:</b>				
Net settlement payments on interest rate swaps		(1,685)		(1,685)
Gain on derivative instruments		2,286		2,286
<b>INCOME FROM CONTINUING OPERATIONS BEFORE MINORITY INTERESTS</b>	<b>22,601</b>	<b>2,724</b>	<b>(1,446)</b>	<b>23,879</b>
<b>MINORITY INTERESTS:</b>				
Minority interest in (earnings) loss of Operating Partnership attributable to continuing operations	(2,138)	(255)	184	(2,209)
Income from continuing operations	15,505	2,469	(1,262)	16,712

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Net income	15,408	2,469		17,877
Net income available to common stockholders	13,838	2,469		16,307
Income from continuing operations per common share basic	\$ 0.55	\$ 0.03	\$ (0.04)	\$ 0.54
Income from continuing operations per common share diluted	\$ 0.55	\$ 0.02	\$ (0.04)	\$ 0.53
Net income per common share basic	\$ 0.49	\$ 0.09	\$	\$ 0.58
Net income per common share diluted	\$ 0.49	\$ 0.09	\$	\$ 0.58

- (1) Includes the discontinued operations that have resulted from the disposition of the five operating properties that were sold subsequent to June 30, 2004. The table above does not reflect all line items in the consolidated statements of operations that were impacted by the reclassification of subsequent dispositions.

Table of Contents**KILROY REALTY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Consolidated Statements of Cash Flows*

	Six Months Ended June 30, 2005			Six Months Ended June 30, 2004		
	As Previously Reported	Restatement	As Restated	As Previously Reported	Restatement	As Restated
		(in thousands)			(in thousands)	
Net cash provided by operating activities	\$ 52,081	\$ 780	\$ 52,861	\$ 42,884	\$ 8,939	\$ 51,823
Net cash used in investing activities	(24,518)	(780)	(25,298)	(5,818)	(2,716)	(8,534)
Net cash used in financing activities	(24,710)		(24,710)	(39,514)	(6,223)	(45,737)

## **Table of Contents**

### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion relates to the consolidated financial statements of the Company and should be read in conjunction with the financial statements and notes thereto appearing elsewhere in this report. Statements contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations that are not historical facts may be forward-looking statements. Such statements are subject to certain risks and uncertainties, which could cause actual results to differ materially from those projected. Some of the information presented is forward-looking in nature, including information concerning projected future occupancy rates, rental rate increases, project development timing and investment amounts. Although the information is based on the Company's current expectations, actual results could vary from expectations stated in this report. Numerous factors will affect the Company's actual results, some of which are beyond its control. These include the timing and strength of regional economic growth, the strength of commercial and industrial real estate markets, competitive market conditions, future interest rate levels and capital market conditions. You are cautioned not to place undue reliance on this information, which speaks only as of the date of this report. The Company assumes no obligation to update publicly any forward-looking information, whether as a result of new information, future events or otherwise, except to the extent the Company is required to do so in connection with its ongoing requirements under federal securities laws to disclose material information. For a discussion of important risks related to the Company's business and an investment in its securities, including risks that could cause actual results and events to differ materially from results and events referred to in the forward-looking information contained in this report, see the discussion under the caption Business Risks in the Company's annual report on Form 10-K, as amended, for the year ended December 31, 2004 and under the caption Factors That May Influence Future Results of Operations below. In light of these risks, uncertainties and assumptions, the forward-looking events described in this report may not occur.

#### **Impact of Restatements and Reclassifications**

Management's Discussion and Analysis of Financial Condition and Results of Operations has been updated to reflect the restatements of the consolidated financial statements. For a more detailed description of the restatements and reclassifications, see Note 14 to the accompanying consolidated financial statements included in this Form 10-Q/A.

#### **Overview and Background**

Kilroy Realty Corporation (the Company) owns, operates, and develops office and industrial real estate, primarily in Southern California. The Company operates as a self-administered real estate investment trust (REIT). The Company owns its interests in all of its properties through Kilroy Realty, L.P. (the Operating Partnership) and Kilroy Realty Finance Partnership, L.P. (the Finance Partnership) and conducts substantially all of its operations through the Operating Partnership. The Company owned an 88.6% and 87.4% general partnership interest in the Operating Partnership as of June 30, 2005 and 2004, respectively. The Company conducts substantially all of its development services through Kilroy Services, LLC, which is a wholly owned subsidiary of the Operating Partnership.

#### **Factors That May Influence Future Results of Operations**

*Rental income.* The amount of net rental income generated by the Company's properties depends principally on its ability to maintain the occupancy rates of currently leased space and to lease currently available space, newly developed or redeveloped properties and space available from unscheduled lease terminations. The amount of rental income generated by the Company also depends on its ability to maintain or increase rental rates in its submarkets. Negative trends in one or more of these factors could adversely affect the Company's rental income in future periods.



*Rental rates.* For leases that commenced during the three months ended June 30, 2005, rental rates decreased 11.3% on a GAAP basis, and 16.7% on a cash basis. Rental rates for leases that commenced during the

**Table of Contents**

six months ended June 30, 2005 decreased 1.3% on a GAAP basis, and 10.1% on a cash basis. The change in rental rate on a cash basis is calculated as the change between the initial stated rent for a new or renewed lease and the ending stated rent for the expiring lease for the same space, whereas the change in rental rate on a GAAP basis compares the average rents over the term of the lease for each lease. Both calculations exclude leases for which the space was vacant longer than one year. The decrease in rental rates for both the three and six months ended June 30, 2005 was primarily due to one lease the Company renewed with a tenant located in one office complex in Seattle, Washington which had a decrease in the rental rate of 62.0% and 63.6% on a GAAP and cash basis, respectively. The substantial decline in rental rates was mainly attributable to the prior lease having a term of approximately twenty-five years. Since this lease had periodic rent escalations and the lease term was longer than the Company's average lease term, the ending rental rate was significantly above market. Excluding this lease, the change in rental rates on a GAAP basis would have been an increase of 3.3% for the three months ended June 30, 2005 and an increase of 7.1% for the six months ended June 30, 2005. The change in rental rates on a cash basis would have been a decrease of 3.1% for the three months ended June 30, 2005 and a decrease of 2.9% for the six months ended June 30, 2005. Management believes that the average rental rates for its properties are approximately at the current average quoted market rates, although individual properties within any particular submarket presently may be leased above or below the current quoted market rates within that submarket. The Company cannot give any assurance that leases will be renewed or that available space will be re-leased at rental rates equal to or above the current quoted market rates.

*Scheduled lease expirations.* In addition to the 574,100 square feet of currently available space in the Company's stabilized portfolio, leases representing approximately 3.1% and 7.5% of the leased square footage of the Company's stabilized portfolio are scheduled to expire during the remainder of 2005 and 2006, respectively. The leases scheduled to expire during the remainder of 2005 and the leases scheduled to expire in 2006 represent approximately 0.8 million square feet of office space, or 8.4% of the Company's total annualized base rent, and 0.4 million square feet of industrial space, or 1.7% of the Company's total annualized base rent, respectively. Management believes that the average rental rates for leases scheduled to expire during the remainder of 2005 are approximately 5% to 10% over the current average quoted market rates. The Company's ability to re-lease available space depends upon the market conditions in the specific submarkets in which the properties are located.

*Submarket Information*

*Los Angeles County.* There have been modest signs of improvement in market conditions in the overall Los Angeles County region during the last two years, based on third-party reports of positive absorption and decreased levels of direct vacancy as well as an increased level of interest in leasing opportunities at the Company's properties. Most notable have been the improvements seen in the West Los Angeles and Long Beach submarkets. The El Segundo submarket remains the Company's most significant leasing challenge as management continues to see only mild signs of improvement in this region. At June 30, 2005, the Company's Los Angeles stabilized office portfolio was 94% occupied with approximately 158,900 vacant rentable square feet as compared to 91% occupied with approximately 257,100 vacant rentable square feet at December 31, 2004. As of June 30, 2005, leases representing an aggregate of approximately 68,600 and 249,600 rentable square feet are scheduled to expire during the remainder of 2005 and 2006, respectively, in this region.

The Los Angeles stabilized portfolio includes an office building that was developed by the Company that has not yet reached stabilized occupancy. The building, which is located in a two-building office complex in the El Segundo submarket, was added to the stabilized portfolio in the third quarter of 2003 since one year had passed following substantial completion. This building encompasses approximately 127,900 rentable square feet and was approximately 61% occupied as of June 30, 2005 compared to 37% as of December 31, 2004. As of the date of this report, the Company has executed leases on an additional 36,000 square feet of space in this building. As a result, the percentage of square feet leased at this building has increased to 89% from 61% as of June 30, 2005. Within the same complex in El Segundo, the Company has one office redevelopment project encompassing approximately 241,600 rentable square feet which was in the lease-up phase as of June 30, 2005. The Company

## Table of Contents

has executed leases or letters of intent for 25% of the rentable square feet at this building as of the date of this report. In the third quarter of 2005, this project will be added to the stabilized portfolio since one year will have passed following substantial completion.

*San Diego County.* San Diego County remains one of the strongest markets in Southern California real estate based on third-party reports of positive absorption, increased rental rates and growing tenant demand. The Company continues to expand its presence in this market by aggressively seeking and obtaining development opportunities in the region. See additional information regarding the Company's development projects under the caption Development and redevelopment programs. As of June 30, 2005, the Company's San Diego stabilized office portfolio was 94% occupied with approximately 204,000 vacant rentable square feet compared to 97% occupied with approximately 102,300 vacant rentable square feet as of December 31, 2004. The decrease in occupancy is primarily attributable to one redevelopment project, encompassing approximately 68,000 rentable square feet, that was previously in the lease-up phase and was added to the stabilized portfolio during the first quarter of 2005 since one year had passed following substantial completion. As of June 30, 2005 this project had not been leased. Leases representing an aggregate of approximately 130,000 and 210,200 rentable square feet are scheduled to expire during the remainder of 2005 and 2006, respectively, in this region.

*Orange County.* As of June 30, 2005, the Company's Orange County properties were 99% occupied with approximately 61,700 vacant rentable square feet. As of June 30, 2005, leases representing an aggregate of approximately 137,300 and 335,500 rentable square feet were scheduled to expire during the remainder of 2005 and 2006, respectively, in this region.

*Sublease space.* Of the Company's leased space at June 30, 2005, approximately 521,800 rentable square feet, or 4.4%, of the square footage in the Company's stabilized portfolio was available for sublease, as compared to 435,200 rentable square feet, or 3.5% at December 31, 2004. Of the 4.4% of available sublease space in the Company's stabilized portfolio as of June 30, 2005, approximately 3.8% was vacant space and the remaining 0.6% was occupied. Approximately 60% and 36% of the available sublease space as of June 30, 2005 is located in the Orange County and San Diego submarkets, respectively. Of the approximately 521,800 rentable square feet available for sublease at June 30, 2005, none is scheduled to expire in 2005. Approximately 20,700 rentable square feet represents leases scheduled to expire during 2006.

Negative trends or other events that impair the Company's ability to renew or re-lease space and its ability to maintain or increase rental rates in its submarkets could have an adverse effect on the Company's future financial condition, results of operations and cash flows.

### *Recent Information Regarding Significant Tenants*

*The Boeing Company.* As of June 30, 2005, the Company's largest tenant, The Boeing Company, leased an aggregate of approximately 803,200 rentable square feet of office space under seven separate leases, representing approximately 5.5% of the Company's total annual base rental revenues. In April 2005, The Boeing Company extended, renewed or otherwise modified three of its existing leases. It extended one lease, which was scheduled to expire in January 2006, at a building located in El Segundo, encompassing approximately 101,000 rentable square feet. The extended lease expires in January 2007 and can be terminated by either party with 60-days advance notice anytime after April 30, 2006. The Boeing Company also renewed one lease at a building located in Anaheim, encompassing approximately 65,500 rentable square feet. The lease, which was originally scheduled to expire in October 2005, was extended through October 2010. In addition, an amendment was signed for a lease in Long Beach whereby The Boeing Company reduced its rentable square feet from 43,600 rentable square feet to 15,500 rentable square feet. The Boeing Company paid rent on the entire 43,600 rentable square feet through May 31, 2005. For the period June 1, 2005 through September 30, 2005, The Boeing Company will continue to occupy and pay rent on 15,500 rentable square feet. In addition to the lease for 15,500 rentable square feet that expires on September 30, 2005, The Boeing Company has another lease in Long Beach for approximately 10,700 rentable square feet that expires on August 31, 2005. The Boeing Company is expected to move out upon expiration of both Long Beach leases. Furthermore, one lease, encompassing approximately



## Table of Contents

211,100 rentable square feet, is scheduled to expire in December 2007; however, under the terms of the lease, The Boeing Company has the right to terminate this lease effective December 31, 2006 by giving the Company written notice one year in advance. The remaining two leases for approximately 286,000 and 113,000 rentable square feet are scheduled to expire on July 31, 2007 and March 31, 2009, respectively.

*Intuit, Inc.* As of June 30, 2005, Intuit, Inc. ( Intuit ), the Company's sixth largest tenant, leased an aggregate of approximately 278,700 rentable square feet of office space under four separate leases, representing approximately 2.2% of the Company's total annual base rental revenues. In March 2005, the Company executed a ten-year lease agreement with Intuit for approximately 365,000 rentable square feet of additional space. Under this agreement, Intuit will lease three of the four buildings in an office complex that the Company has committed to develop in the I-56 Corridor submarket in San Diego County. See additional information regarding the Company's development projects under the caption

Development and redevelopment programs. The agreement also provides Intuit with the option to lease the fourth building. One of the earlier leases, encompassing approximately 212,000 rentable square feet, is scheduled to expire in April 2007. In connection with the new lease agreement, Intuit has the option to remain in approximately 141,000 rentable square feet of this space until it can occupy the new buildings, which is expected to be in the third quarter of 2007. In addition, Intuit has the option to extend this lease for the remaining 71,000 rentable square feet for up to two years. This second option must be exercised by January 1, 2006. Intuit also has two leases in Calabasas which encompass approximately 49,000 and 14,000 rentable square feet and are both scheduled to expire in July 2014. The last lease with Intuit is located in Long Beach and encompasses approximately 3,000 rentable square feet. This lease is scheduled to expire in December 2005. Upon commencement of the new San Diego lease, Intuit is projected to become the Company's largest tenant based on its percentage of the Company's total annual base rent.

*Development and redevelopment programs.* Management believes that a significant portion of the Company's potential growth over the next several years will continue to come from its development pipeline. During 2002 and 2003, the Company scaled back its development activity as a result of the economic environment and its impact on the Company's ability to lease projects within budgeted timeframes. However, as San Diego County remains one of the strongest markets in Southern California, the Company has continued to aggressively seek and obtain development opportunities in the region.

In March 2005, the Company committed to develop a four-building office complex in the I-56 Corridor submarket of San Diego County. The Company has pre-leased three of the four buildings, or 78% of the rentable square feet, to a single tenant and expects to complete the project by the third quarter of 2007. The project has a total estimated investment of approximately \$145 million and will encompass an aggregate of approximately 466,000 rentable square feet. See additional information under the caption Recent Information Regarding Significant Tenants Intuit, Inc. In June 2005, the Company acquired approximately 11.3 acres of undeveloped land located immediately adjacent to this project. The land site includes entitlements to build approximately 350,000 rentable square feet of office space.

In June 2005, the Company executed a lease agreement with a single tenant for a new three-building corporate headquarters in its Innovation Corporate Center, located in the San Diego County I-15 Corridor submarket. Two of the buildings, encompassing an aggregate of approximately 103,000 rentable square feet, are currently under construction and are scheduled to be completed in the fourth quarter of 2005. The Company plans to commence construction on the third building, which will encompass approximately 75,000 rentable square feet, in the first quarter of 2006. The total estimated investment for the three buildings is approximately \$44 million.

The Company also owns approximately 49.5 acres of undeveloped land, including the 11.3 acres acquired in June 2005, upon which the Company currently expects to develop an aggregate of approximately 1.1 million rentable square feet of office space within the next three to five years. All of the Company's undeveloped land is located in San Diego County. See additional information regarding the Company's development portfolio under the caption Development and Redevelopment in this report.

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**Table of Contents**

Management believes that another possible source of the Company's potential growth over the next several years is redevelopment opportunities within its existing portfolio. Redevelopment efforts can achieve similar returns to new development with reduced entitlement risk and shorter construction periods. The Company's redevelopment portfolio currently consists of an office building in El Segundo for which the Company performed extensive interior refurbishments. The building had previously been occupied by a single tenant for approximately 30 years. This project, which encompasses approximately 241,600 rentable square feet, was completed in 2004 and will be added to the stabilized portfolio in the third quarter of 2005. As of June 30, 2005, the Company has executed leases or letters of intent for 25% of the rentable square feet at this building. See additional information regarding the Company's in-process redevelopment portfolio under the caption "Development and Redevelopment" in this report. Depending on market conditions, the Company will continue to pursue future redevelopment opportunities in its strategic submarkets where no land available for development exists.

The Company has a proactive planning process by which it continually evaluates the size, timing and scope of its development and redevelopment programs and, as necessary, scales activity to reflect the economic conditions and the real estate fundamentals that exist in the Company's strategic submarkets. However, the Company may be unable to lease committed development or redevelopment properties at expected rental rates or within projected timeframes or complete projects on schedule or within budgeted amounts, which could adversely affect the Company's financial condition, results of operations and cash flows.

*Other Factors.* The Company's operating results are and may continue to be affected by uncertainties and problems associated with the deregulation of the utility industry in California, since 95.6% of the total rentable square footage of the Company's stabilized portfolio is located in California. Energy deregulation has resulted in higher utility costs in some areas of the state and intermittent service interruptions. In addition, primarily as a result of the events of September 11, 2001, the Company's annual insurance costs increased across its portfolio by approximately 14%, 11% and 12% during 2002, 2003 and 2004, respectively. However, insurance costs have remained relatively constant for the six months ended June 30, 2005 as compared to the same period in 2004. As of the date of this report, the Company had not experienced any material effects arising from either of these issues.

In addition, the California State legislature is currently evaluating split tax roll legislation, which if enacted, could have a material effect on the Company's operating results. If this initiative is passed as currently proposed, the tax rate on commercial property in California would increase, which would result in significant increases in real estate taxes for the Company's properties located in California, having an adverse impact on net income.

*Incentive Compensation.* The Company has long-term incentive compensation programs that provide for cash and stock compensation to be earned by the Company's senior officers if the Company attains certain performance measures that are based on annualized stockholder returns on an absolute and a relative basis as well as certain other financial, operating and development targets. As a result, accrued incentive compensation in future periods is affected by the ten-day average closing price per share of the Company's common stock at the end of each quarter. Future increases or decreases in the price per share of the Company's common stock and the resultant cumulative annualized stockholder return calculations will cause an increase or decrease to general and administrative expenses and a corresponding decrease or increase to net income available to common stockholders. Under the absolute component of a special long-term plan for the Company's executive officers, every \$1 change in the Company's ten-day average closing stock price equates to an approximate \$1.7 million change in the total amount payable at the end of the three-year term of the plan (see Note 8 to the Company's consolidated financial statements for further discussion about the program). Management cannot predict the amounts that will be ultimately recorded in future periods related to these programs since they are significantly influenced by the Company's stock price and market conditions.

**Table of Contents****Results of Operations**

As of June 30, 2005, the Company's stabilized portfolio was comprised of 83 office properties (the Office Properties) encompassing an aggregate of approximately 7.6 million rentable square feet, and 47 industrial properties (the Industrial Properties, and together with the Office Properties, the Properties), encompassing an aggregate of approximately 4.4 million rentable square feet. The Company's stabilized portfolio of operating properties consists of all the Properties, and excludes properties recently developed or redeveloped by the Company that have not yet reached 95.0% occupancy and are within one year following substantial completion (lease-up properties) and projects currently under construction.

As of June 30, 2005, the Office and Industrial Properties represented 84.6% and 15.4%, respectively, of the Company's annualized base rent. For the three months ended June 30, 2005, average occupancy in the Company's stabilized portfolio was 94.4% compared to 91.7% for the three months ended June 30, 2004. As of June 30, 2005, the Company had approximately 574,100 rentable square feet of vacant space in its stabilized portfolio compared to 968,600 rentable square feet as of June 30, 2004.

The following table reconciles the changes in the rentable square feet in the Company's stabilized portfolio of operating properties from June 30, 2004 to June 30, 2005. Rentable square footage in the Company's portfolio of stabilized properties decreased by approximately 0.1 million to 12.0 million at June 30, 2005, compared to 12.1 million at June 30, 2004.

	Office Properties		Industrial Properties		Total	
	Number of Buildings	Square Feet	Number of Buildings	Square Feet	Number of Buildings	Square Feet
Total at June 30, 2004	81	7,184,648	50	4,878,604	131	12,063,252
Acquisitions	3	327,730			3	327,730
Properties added from the Development Portfolio	1	208,464			1	208,464
Properties added from the Redevelopment Portfolio	1	67,995			1	67,995
Dispositions and property reclassified as held for sale(1)(2)	(3)	(174,309)	(3)	(521,734)	(6)	(696,043)
Remeasurement		(7,301)		1,038		(6,263)
Total at June 30, 2005	83	7,607,227	47	4,357,908	130	11,965,135

(1) In accordance with Financial Accounting Standards No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144) the operating results and gains or (losses) on property sales of real estate assets sold and held for sale are included in discontinued operations in the consolidated statement of operations.

(2) Includes one industrial property that was classified as held for sale as of June 30, 2005.

**Table of Contents****Comparison of the Three Months Ended June 30, 2005 to the Three Months Ended June 30, 2004**

Management internally evaluates the operating performance and financial results of its portfolio based on Net Operating Income for the following segments of commercial real estate property: Office Properties and Industrial Properties. The Company defines Net Operating Income as operating revenues from continuing operations (rental income, tenant reimbursements and other property income) less property and related expenses from continuing operations (property expenses, real estate taxes, provision for bad debts and ground leases). The Net Operating Income segment information presented within this Management's Discussion and Analysis consists of the same Net Operating Income segment information disclosed in Note 10 of the Company's consolidated financial statements in accordance with Statement of Financial Accounting Standards No. 131 Disclosures about Segments of an Enterprise and Related Information. The following table reconciles the Company's Net Operating Income by segment to the Company's net income available to common stockholders for the three months ended June 30, 2005 and 2004.

	Three Months		Dollar Change	Percentage Change
	Ended			
	June 30,			
	2005	2004		
	(\$ in thousands)			
<b>Net Operating Income, as defined:</b>				
Office Properties	\$ 37,847	\$ 32,948	\$ 4,899	14.9%
Industrial Properties	7,484	7,437	47	0.6
Total portfolio	45,331	40,385	4,946	12.2
<b>Reconciliation to Consolidated Net Income:</b>				
Net Operating Income, as defined for reportable segments	45,331	40,385	4,946	12.2
Other expenses:				