

KILROY REALTY CORP
Form 10-Q/A
August 18, 2005
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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 September 30, 2004

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 x No "

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

As of October 26, 2004, 28,527,920 shares of common stock, par value \$.01 per share, were outstanding.

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EXPLANATORY NOTE

This Amendment No. 1 on Form 10-Q/A (the "Amended Filing") of Kilroy Realty Corporation (the "Company") for the quarterly period ended September 30, 2004 (the "Original Filing") is being filed to restate the Company's income from continuing operations per common share included within its consolidated statements of operations for the three and nine months ended September 30, 2004 and the notes related thereto, 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. As originally filed, the quarterly report for the three and nine months ended September 30, 2004 incorrectly reflected income from continuing operations per common share before deducting the dividends paid and accrued. The calculation error had no impact on income from continuing operations, net income, net income per share, the Company's consolidated balance sheets, consolidated statement of stockholders' equity and consolidated statements of cash flows, or the calculation of funds from operations. The only line items required to be restated to correct this calculation error are the per share amounts for income from continuing operations, basic and diluted, included within the consolidated statements of operations. The Amended Filing is also being filed to restate the consolidated statements of cash flows for the nine months ended September 30, 2004 and 2003. As originally filed, two items in the consolidated statements of cash flows were incorrectly classified. First, distributions to cumulative redeemable preferred unitholders were included in the Company's consolidated statements of cash flows as an operating activity and 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. 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. For a more detailed description of the restatements, see Note 14 to the accompanying consolidated financial statements contained in this Form 10-Q/A. 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 on Form 10-Q/A 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 income from continuing operations per common share included within its consolidated statements of operations and the consolidated statements of cash flows for the same reclassifications noted above. The decision to 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 July 21, 2005 and August 9, 2005.

The Company has also updated its historical financial statements in this Form 10-Q/A for discontinued operations that have resulted from the disposition of four operating properties during the six months ended June 30, 2005 and the classification of a property as held for sale as of June 30, 2005 in accordance with Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" (SFAS 144). This SFAS 144 treatment had no effect on the net income available to common stockholders or the Company's financial condition. The other concurrently filed amendments referenced above reflect similar updates.

To reflect the restatements of the consolidated statements of cash flows for the reclassifications described above and the update for discontinued operations, the Company is also re-issuing the Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") 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.

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KILROY REALTY CORPORATION

QUARTERLY REPORT FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2004

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

| | September 30, 2004 | December 31, 2003 |
|---|-------------------------------|------------------------------|
| | <u> </u> | <u> </u> |
| <u>ASSETS</u> | | |
| REAL ESTATE ASSETS (Notes 2 and 3): | | |
| Land and improvements | \$ 288,861 | \$ 289,730 |
| Buildings and improvements, net | 1,357,626 | 1,305,145 |
| Undeveloped land and construction in progress, net | 84,218 | 131,411 |
| | <u> </u> | <u> </u> |
| Total real estate held for investment | 1,730,705 | 1,726,286 |
| Accumulated depreciation and amortization | (353,025) | (321,372) |
| | <u> </u> | <u> </u> |
| Total real estate assets, net | 1,377,680 | 1,404,914 |
| CASH AND CASH EQUIVALENTS | 3,652 | 9,892 |
| RESTRICTED CASH (Note 4) | 1,283 | 8,558 |
| CURRENT RECEIVABLES, NET | 4,190 | 4,919 |
| DEFERRED RENT RECEIVABLES, NET | 43,956 | 36,804 |
| DEFERRED LEASING COSTS, NET | 39,420 | 36,651 |
| DEFERRED FINANCING COSTS, NET | 3,190 | 3,657 |
| PREPAID EXPENSES AND OTHER ASSETS | 6,008 | 7,240 |
| | <u> </u> | <u> </u> |
| TOTAL ASSETS | \$ 1,479,379 | \$ 1,512,635 |
| | <u> </u> | <u> </u> |
| <u>LIABILITIES AND STOCKHOLDERS' EQUITY</u> | | |
| LIABILITIES: | | |
| Secured debt (Note 4) | \$ 494,932 | \$ 526,048 |
| Unsecured senior notes (Note 4) | 144,000 | |
| Unsecured line of credit (Note 4) | 92,000 | 235,000 |
| Accounts payable, accrued expenses and other liabilities (Note 5) | 52,889 | 41,147 |
| Accrued distributions (Note 13) | 16,498 | 16,369 |
| Rents received in advance, tenant security deposits and deferred revenue | 19,974 | 20,904 |
| | <u> </u> | <u> </u> |
| Total liabilities | 820,293 | 839,468 |
| | <u> </u> | <u> </u> |
| COMMITMENTS AND CONTINGENCIES | | |
| MINORITY INTERESTS (Note 6): | | |
| 7.45% (8.075% as of December 31, 2003) Series A Cumulative Redeemable Preferred unitholders | 73,638 | 73,716 |
| 9.25% Series D Cumulative Redeemable Preferred unitholders | 44,321 | 44,321 |

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| | | |
|---|---------------------|---------------------|
| Common unitholders of the Operating Partnership | 61,782 | 66,502 |
| | <u> </u> | <u> </u> |
| Total minority interests | 179,741 | 184,539 |
| | <u> </u> | <u> </u> |
| STOCKHOLDERS EQUITY (Note 7): | | |
| Preferred stock, \$.01 par value, 25,290,000 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, 1,610,000 shares authorized, issued and outstanding | 38,425 | 38,437 |
| Common stock, \$.01 par value, 150,000,000 shares authorized, 28,527,920 and 28,209,213 shares issued and outstanding, respectively | 286 | 282 |
| Additional paid-in capital | 515,086 | 508,568 |
| Deferred compensation | (1,929) | (852) |
| Distributions in excess of earnings | (71,456) | (53,449) |
| Accumulated net other comprehensive loss (Note 5) | (1,067) | (4,358) |
| | <u> </u> | <u> </u> |
| Total stockholders equity | 479,345 | 488,628 |
| | <u> </u> | <u> </u> |
| TOTAL LIABILITIES AND STOCKHOLDERS EQUITY | \$ 1,479,379 | \$ 1,512,635 |
| | <u> </u> | <u> </u> |

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 | | Nine Months Ended | |
|--|--------------------|----------------|-------------------|-----------------|
| | September 30, | | September 30, | |
| | 2004 | 2003 | 2004 | 2003 |
| REVENUES (Note 10): | | | | |
| Rental income | \$ 49,554 | \$ 45,112 | \$ 144,389 | \$ 129,452 |
| Tenant reimbursements | 4,717 | 4,380 | 15,102 | 14,590 |
| Other property income (Note 8) | (273) | 18,441 | 391 | 23,312 |
| Total revenues | 53,998 | 67,933 | 159,882 | 167,354 |
| EXPENSES (Note 10): | | | | |
| Property expenses | 8,339 | 7,644 | 25,137 | 22,515 |
| Real estate taxes | 4,295 | 3,749 | 12,250 | 10,917 |
| Provision for bad debts (Note 9) | (522) | 2,733 | 88 | 1,600 |
| Ground leases | 334 | 326 | 996 | 970 |
| General and administrative expenses | 9,399 | 5,089 | 22,342 | 13,231 |
| Interest expense | 9,540 | 8,869 | 27,898 | 24,143 |
| Depreciation and amortization | 14,456 | 14,067 | 42,246 | 40,044 |
| Total expenses | 45,841 | 42,477 | 130,957 | 113,420 |
| OTHER INCOME | | | | |
| Interest and other income (Note 8) | 77 | 36 | 462 | 130 |
| Total other income | 77 | 36 | 462 | 130 |
| INCOME FROM CONTINUING OPERATIONS BEFORE MINORITY INTERESTS | 8,234 | 25,492 | 29,387 | 54,064 |
| MINORITY INTERESTS: | | | | |
| Distributions on Cumulative Redeemable Preferred units (Note 6) | (2,437) | (3,375) | (7,396) | (10,125) |
| Minority interest in earnings of Operating Partnership attributable to continuing operations | (531) | (2,931) | (2,485) | (5,845) |
| Total minority interests | (2,968) | (6,306) | (9,881) | (15,970) |
| INCOME FROM CONTINUING OPERATIONS | 5,266 | 19,186 | 19,506 | 38,094 |
| DISCONTINUED OPERATIONS (Notes 2 and 11) | | | | |
| Revenues from discontinued operations | 1,414 | 2,129 | 5,876 | 8,165 |
| Expenses from discontinued operations | (900) | (1,100) | (3,236) | (4,620) |
| Net gain (loss) on disposition of discontinued operations | 6,212 | (48) | 6,148 | 3,642 |
| Impairment loss on property held for sale | | | (726) | |
| Minority interest in earnings of Operating Partnership attributable to discontinued operations | (850) | (128) | (1,019) | (956) |

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| | | | | |
|--|------------|------------|------------|------------|
| Total income from discontinued operations | 5,876 | 853 | 7,043 | 6,231 |
| NET INCOME | 11,142 | 20,039 | 26,549 | 44,325 |
| PREFERRED DIVIDENDS | (785) | | (2,355) | |
| NET INCOME AVAILABLE FOR COMMON SHAREHOLDERS | \$ 10,357 | \$ 20,039 | \$ 24,194 | \$ 44,325 |
| Income from continuing operations per common share basic (Note 12) (As Restated, see Note 14) | \$ 0.16 | \$ 0.70 | \$ 0.61 | \$ 1.39 |
| Income from continuing operations per common share diluted (Note 12) (As Restated, see Note 14) | \$ 0.16 | \$ 0.69 | \$ 0.60 | \$ 1.38 |
| Net income per common share basic (Note 12) | \$ 0.37 | \$ 0.73 | \$ 0.86 | \$ 1.62 |
| Net income per common share diluted (Note 12) | \$ 0.36 | \$ 0.72 | \$ 0.85 | \$ 1.61 |
| Weighted average shares outstanding basic (Note 12) | 28,271,214 | 27,584,345 | 28,202,925 | 27,386,930 |
| Weighted average shares outstanding diluted (Note 12) | 28,439,665 | 27,800,542 | 28,368,505 | 27,593,126 |
| Dividends declared per common share | \$ 0.495 | \$ 0.495 | \$ 1.485 | \$ 1.485 |

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 | | | | | Distributions in Excess of Earnings | Accumulated Net Other Comp. Loss | Total |
|---|--------------------|---------------------|-----------------|----------------------------------|--------------------------|---|---|------------|
| | Preferred Stock | Number of Shares | Common Stock | Additional Paid-in Capital | Deferred Compensation | | | |
| BALANCE AT DECEMBER 31, 2003 | \$ 38,437 | 28,209,213 | \$ 282 | \$ 508,568 | \$ (852) | \$ (53,449) | \$ (4,358) | \$ 488,628 |
| Net income | | | | | | 26,549 | | 26,549 |
| Net other comprehensive income | | | | | | | 3,291 | 3,291 |
| Comprehensive income | | | | | | | | 29,840 |
| Issuance costs of preferred stock | (12) | | | | | | | (12) |
| Issuance of restricted stock (Note 7) | | 114,843 | 1 | 3,994 | (2,751) | | | 1,244 |
| Exercise of stock options | | 76,991 | 1 | 1,598 | | | | 1,599 |
| Non-cash amortization of restricted stock | | | | | 1,674 | | | 1,674 |
| Repurchase of common stock (Note 7) | | (36,955) | | (1,275) | | | | (1,275) |
| Conversion of common limited partnership units of the Operating Partnership (Note 6) | | 163,828 | 2 | 4,399 | | | | 4,401 |
| Stock option expense (Note 1) | | | | 20 | | | | 20 |
| Adjustment for minority interest (Note 1) | | | | (2,218) | | | | (2,218) |
| Preferred dividends | | | | | | (2,355) | | (2,355) |
| Dividends declared (\$1.485 per share) | | | | | | (42,201) | | (42,201) |
| BALANCE AT SEPTEMBER 30, 2004 | \$ 38,425 | 28,527,920 | \$ 286 | \$ 515,086 | \$ (1,929) | \$ (71,456) | \$ (1,067) | \$ 479,345 |

See accompanying notes to consolidated financial statements.

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

| | Nine Months Ended September 30, | |
|---|--|-----------------|
| | 2004 | 2003 |
| | (As Restated, Note 14) | |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 26,549 | \$ 44,325 |
| 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 | 42,974 | 41,200 |
| Impairment loss on property held for sale | 726 | |
| Distributions on Cumulative Redeemable Preferred units | 7,396 | 10,125 |
| Minority interest in earnings of Operating Partnership | 3,504 | 6,801 |
| Non-cash amortization of restricted stock grants | 2,526 | 2,358 |
| Non-cash amortization of deferred financing costs | 2,397 | 1,721 |
| (Decrease) increase in provision for uncollectible tenant receivables | (607) | 2,243 |
| Increase (decrease) in provision for uncollectible unbilled deferred rent | 738 | (551) |
| Depreciation of furniture, fixtures and equipment | 681 | 719 |
| Net gain on dispositions of operating properties | (6,148) | (3,642) |
| Other | 9 | 77 |
| Changes in assets and liabilities: | | |
| Current receivables | 1,336 | (1,593) |
| Deferred rent receivables | (8,425) | (4,669) |
| Deferred leasing costs | (2,047) | (658) |
| Prepaid expenses and other assets | 543 | (753) |
| Accounts payable, accrued expenses and other liabilities | 13,142 | 2,755 |
| Rents received in advance, tenant security deposits and deferred revenue | (930) | (2,740) |
| Net cash provided by operating activities | 84,364 | 97,718 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Expenditures for operating properties | (20,129) | (20,448) |
| Expenditures for undeveloped land and construction in progress | (22,138) | (49,677) |
| Net proceeds received from dispositions of operating properties | 33,439 | 34,076 |
| Decrease (increase) in restricted cash | 7,275 | (1,983) |
| Net cash used in investing activities | (1,553) | (38,032) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from borrowings or issuance of secured debt | 115,218 | 105,587 |
| Proceeds from the issuance of unsecured senior notes | 144,000 | |
| Net repayments on unsecured line of credit | (143,000) | (33,000) |
| Principal payments on secured debt | (146,334) | (83,785) |
| Distributions paid to common stockholders and common unitholders | (48,172) | (47,097) |
| Repurchase of common stock (Note 7) | (1,275) | (1,714) |
| Financing costs | (1,331) | (357) |
| Proceeds from exercise of stock options | 1,599 | 11,106 |
| Distributions paid to preferred shareholders and preferred unitholders | (9,756) | (10,125) |

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| | | |
|---|-----------|-----------|
| Net cash used in financing activities | (89,051) | (59,385) |
| Net (decrease) increase in cash and cash equivalents | (6,240) | 301 |
| Cash and cash equivalents, beginning of period | 9,892 | 15,777 |
| Cash and cash equivalents, end of period | \$ 3,652 | \$ 16,078 |
| SUPPLEMENTAL CASH FLOW INFORMATION: | | |
| Cash paid for interest, net of capitalized interest of \$5,707 and \$8,727 at September 30, 2004 and 2003, respectively | \$ 24,117 | \$ 21,208 |
| NON-CASH TRANSACTIONS: | | |
| Accrual of distributions payable to common unitholders and shareholders (Note 13) | \$ 16,097 | \$ 15,960 |
| Receipt of stock (Note 8) | \$ 494 | |

See accompanying notes to consolidated financial statements.

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KILROY REALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Nine Months Ended September 30, 2004 and 2003

(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 September 30, 2004, the Company's stabilized portfolio of operating properties consisted of 82 office buildings (the *Office Properties*) and 49 industrial buildings (the *Industrial Properties*), which encompassed an aggregate of approximately 7.4 million and 4.6 million rentable square feet, respectively, and was 93.1% 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 or lease-up properties.

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 September 30, 2004 the Company had two redevelopment properties encompassing approximately 309,600 rentable square feet, each of which was in the lease-up phase. In addition, as of September 30, 2004 the Company had two development properties under construction, which when completed are expected to encompass approximately 103,300 rentable square feet.

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 87.7% general partnership interest in the Operating Partnership as of September 30, 2004. 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. 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, as of December 31, 2003, was owned 99.0% by the Operating Partnership and 1.0% by the Company. On January 1, 2004, KSLLC became 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.

Net income after preferred distributions 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

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KILROY REALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

result, all capital transactions result in an allocation between the stockholders' equity and Minority Interest 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. The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the year ended December 31, 2004. These financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2003.

Reclassifications

Certain prior year 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 all periods presented.

Recent Accounting Pronouncements

In April 2004, the Financial Accounting Standards Board (FASB) issued FASB Staff Position FAS 129-1, Disclosure Requirements under FASB Statement No. 129, Disclosure of Information about Capital Structure, Relating to Contingently Convertible Financial Instruments (FSP FAS 129-1). FSP FAS 129-1 provides guidance on disclosures of contingently convertible financial instruments, including those containing contingent conversion requirements that have not been met and are not otherwise required to be included in the calculation of diluted earnings per share. The statement was effective immediately, and applies to all existing and newly created securities. The adoption of this statement did not 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 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.

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

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 | | Nine Months Ended | |
|--|---|------------------|--------------------------|------------------|
| | September 30, | | September 30, | |
| | 2004 | 2003 | 2004 | 2003 |
| | (in thousands, except per share amounts) | | | |
| Net income available for common shareholders, as reported | \$ 10,357 | \$ 20,039 | \$ 24,194 | \$ 44,325 |
| Add: Stock option expense included in reported net income | 7 | 7 | 20 | 20 |
| Deduct: Total stock option expense determined under fair value recognition method for all awards | (7) | (29) | (24) | (94) |
| Pro forma net income available for common shareholders | <u>\$ 10,357</u> | <u>\$ 20,017</u> | <u>\$ 24,190</u> | <u>\$ 44,251</u> |
| Net income per common share: | | | | |
| Basic as reported | <u>\$ 0.37</u> | <u>\$ 0.73</u> | <u>\$ 0.86</u> | <u>\$ 1.62</u> |
| Basic pro forma | <u>\$ 0.37</u> | <u>\$ 0.73</u> | <u>\$ 0.86</u> | <u>\$ 1.62</u> |
| Diluted as reported | <u>\$ 0.36</u> | <u>\$ 0.72</u> | <u>\$ 0.85</u> | <u>\$ 1.61</u> |
| Diluted pro forma | <u>\$ 0.36</u> | <u>\$ 0.72</u> | <u>\$ 0.85</u> | <u>\$ 1.61</u> |

2. Dispositions*Dispositions*

During the nine months ended September 30, 2004, the Company sold the following properties:

| <u>Location</u> | <u>Type</u> | <u>Month of Disposition</u> | <u>Number of Buildings</u> | <u>Rentable Square Feet</u> | <u>Sales Price (in millions)</u> |
|-----------------|-------------|-----------------------------|----------------------------|-----------------------------|----------------------------------|
|-----------------|-------------|-----------------------------|----------------------------|-----------------------------|----------------------------------|

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| | | | | | | |
|----------------------------|------------|-----------|----------|----------------|-----------|-------------|
| 3750 University Avenue | | | | | | |
| Riverside, CA | Office | May | 1 | 125,020 | \$ | 19.5 |
| 12752/12822 Monarch Street | | | | | | |
| Garden Grove, CA | Industrial | September | 1 | 277,037 | | 15.3 |
| | | | <u>2</u> | <u>402,057</u> | <u>\$</u> | <u>34.8</u> |
| Total | | | <u>2</u> | <u>402,057</u> | <u>\$</u> | <u>34.8</u> |

During the three and nine months ended September 30, 2004, the Company recorded a net gain of approximately \$6.2 million and \$6.1 million, respectively, in connection with the dispositions. The Company used the net cash proceeds from the sale of these properties to fund its development and redevelopment programs and to repay borrowings under the Credit Facility (defined in Note 4). The Company had classified the office property located in Riverside as held for sale as of March 31, 2004 and recorded a \$0.7 million impairment loss in the first quarter of 2004 to reflect the property on the balance sheet at its estimated fair market value less selling costs. The net income and the net gain on disposition for these properties and the impairment loss have been included in discontinued operations for the three and nine months ended September 30, 2004 and 2003 (see Note 11).

Table of Contents**KILROY REALTY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****3. Development and Redevelopment Projects***Stabilized Development Projects*

During the nine months ended September 30, 2004, the Company added the following development project to the Company's stabilized portfolio:

| <u>Project Name / Submarket</u> | <u>Property Type</u> | <u>Completion Date</u> | <u>Stabilization Date</u> | <u>Number of Buildings</u> | <u>Rentable Square Feet</u> | <u>Percentage Leased</u> |
|---------------------------------|----------------------|------------------------|---------------------------|----------------------------|-----------------------------|--------------------------|
| 12400 High Bluff | | | | | | |
| Del Mar, CA | Office | Q3 2003 | Q3 2004 | 1 | 208,500 | 100% |

Redevelopment Projects in Lease-up

During the nine months ended September 30, 2004, the Company completed the following redevelopment projects, which were in the lease-up phase as of September 30, 2004:

| <u>Project Name / Submarket</u> | <u>Pre and Post Redevelopment Property Type</u> | <u>Completion Date</u> | <u>Estimated Stabilization Date(1)</u> | <u>Number of Buildings</u> | <u>Rentable Square Feet</u> | <u>Percentage Leased</u> |
|--|---|------------------------|--|----------------------------|-----------------------------|--------------------------|
| 5717 Pacific Center Blvd. | | | | | | |
| Sorrento Mesa, CA 909 Sepulveda Blvd. | Office to Life Science | Q1 2004 | Q1 2005 | 1 | 68,000 | 0% |
| El Segundo, CA | Office | Q3 2004 | Q3 2005 | 1 | 241,600 | 19% |
| Total | | | | 2 | 309,600 | 15% |

(1) Based on management's estimation of the earlier of stabilized occupancy (95%) or one year from the date of substantial completion.

4. Unsecured and Secured Debt

As of September 30, 2004, the Company had borrowings of \$92.0 million outstanding under its revolving unsecured line of credit (the Credit Facility) and availability of approximately \$251.4 million. The Credit Facility bore interest at an annual rate between LIBOR plus 1.13% and LIBOR plus 1.75% during the nine months ended September 30, 2004 and 2003 (3.26% at September 30, 2004), depending upon the Company's leverage ratio at the time of borrowing.

On October 22, 2004, the Company obtained a new \$425 million unsecured revolving credit facility (New Credit Facility) to replace the Credit Facility that was scheduled to mature in March 2005. The New 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, 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 New Credit Facility to finance development and redevelopment expenditures, to fund potential acquisitions and for other general corporate uses.

In February 2004, the Company borrowed \$81 million under a mortgage loan that is secured by four office properties in a five-building complex. The loan required interest-only payments based on a variable annual interest rate of LIBOR plus 1.75% through July 2004 and beginning in August 2004 and continuing through August 2012, the scheduled maturity date, the loan required monthly principal and interest payments based on a fixed annual interest rate of 5.57%. The Company used a portion of the proceeds to repay an outstanding

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KILROY REALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

mortgage loan with a principal balance of \$20.3 million that was scheduled to mature in June 2004. The remainder of the proceeds was used primarily to repay borrowings under the Credit Facility.

In March 2004, the Company borrowed \$34 million under a mortgage loan that is secured by the fifth office property in the five-building complex referenced above. The loan required interest-only payments based on a variable annual interest rate of LIBOR plus 1.75% through September 2004 and beginning in October 2004 and continuing through August 2012, the scheduled maturity date, the loan requires monthly principal and interest payments based on a fixed annual interest rate of 4.95%. The Company used the proceeds to repay borrowings under the Credit Facility.

In August 2004, the Company issued two series of unsecured senior notes with an aggregate principal balance of \$144 million. The Series A notes have an aggregate principal balance of \$61 million and mature in August 2010. The Series B notes have an aggregate principal balance of \$83 million and mature in August 2014. The Series A and Series B notes require semi-annual interest payments each February and August based on a fixed annual interest rate of 5.72% and 6.45%, respectively. The Company used the proceeds to repay a mortgage loan with an outstanding principal balance of \$73.8 million that was scheduled to mature in January 2005 and a construction loan with an outstanding principal balance of \$43.8 million that was scheduled to mature in September 2004. The remainder of the proceeds was used primarily to repay borrowings under the Credit Facility.

In connection with the repayment of the mortgage loan, approximately, \$6.3 million in cash became available to the Company as unrestricted funds. This cash was held in connection with credit enhancements and as reserves for property taxes, capital expenditures and capital improvements under the terms of the loan and had previously been classified as restricted cash.

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. Some of the more restrictive financial covenants include a maximum total debt to total assets ratio, a maximum total secured debt to total assets ratio, a 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 September 30, 2004.

Total interest and loan fees capitalized for the three months ended September 30, 2004 and 2003 were \$2.3 million and \$2.5 million, respectively. Total interest and loan fees capitalized for the nine months ended September 30, 2004 and 2003 were \$6.4 million and \$9.8 million, respectively.

5. Derivative Financial Instruments

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The following table sets forth the terms and fair market value of the Company's derivative financial instruments at September 30, 2004:

| <u>Type of Instrument</u> | <u>Notional Amount</u> | <u>Index</u> | <u>Strike</u> | <u>Maturity Date</u> | <u>Fair Market Value</u> |
|--|----------------------------|--------------|---------------|----------------------|------------------------------|
| | (in thousands) | | | | (in thousands) |
| Interest rate swap | \$ 50,000 | LIBOR | 4.46% | January 2005 | \$ (374) |
| Interest rate swap | 50,000 | LIBOR | 2.57 | November 2005 | (64) |
| Interest rate swap | 25,000 | LIBOR | 2.98 | December 2006 | (39) |
| Interest rate swap | 25,000 | LIBOR | 2.98 | December 2006 | (39) |
| Total included in other liabilities | | | | | \$ (516) |

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KILROY REALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In June 2004, the Company terminated two interest rate cap agreements. In accordance with SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, the cost deferred in accumulated other net comprehensive loss (AOCL) associated with the terminated contracts remained in AOCL upon termination because the Company will continue to make interest payments on the associated outstanding debt. The cost is being amortized into interest expense through January 2005, the remaining term of the interest-rate cap agreements.

The instruments described above have been designated as cash flow hedges. As of September 30, 2004, the balance in AOCL was approximately \$1.1 million relating to the net decrease in the fair market value of the derivative instruments since their inception. The \$0.6 million difference between the total fair value of \$0.5 million and the \$1.1 million balance in AOCL represents the deferred cost associated with the terminated interest-rate cap agreements. For the nine months ended September 30, 2004, the Company did not record any gains or losses attributable to cash flow hedge ineffectiveness since the terms of the Company's derivative contracts and debt obligations were and are expected to continue to be effectively matched. Amounts reported in AOCL will be reclassified to interest expense as interest payments are made on the Company's variable-rate debt.

6. Minority Interests

Minority interests represent the common and preferred limited partnership interests in the Operating Partnership. The Company owned an 87.7% general partnership interest in the Operating Partnership as of September 30, 2004.

In March 2004, the Company amended the terms of its Series A Cumulative Redeemable Preferred units (Series A Preferred Units) to reduce the distribution rate, extend the redemption date to September 30, 2009, and create a right of redemption at the option of the holders in the event of certain change of control events, certain repurchases of the Company's publicly registered equity securities, an involuntary delisting of the Company's common stock from the NYSE or a loss of REIT status. Commencing March 5, 2004, distributions on the Series A Preferred Units accrued at an annual rate of 7.45%. Prior to March 5, 2004, distributions on the Series A Preferred Units accrued at an annual rate of 8.075%.

During the nine months ended September 30, 2004, 163,828 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 to the common limited partners.

7. Stockholders' Equity and Employee Incentive Plans

In February 2004, the Company's Compensation Committee granted an aggregate of 111,159 restricted shares of common stock to certain executive officers and key employees. Compensation expense for the restricted shares is calculated based on the closing per share price of \$34.85 on the February 10, 2004 grant date and is amortized on a straight-line basis over the performance and vesting periods. Of the shares

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granted, 21,234 vest at the end of a one-year period, 68,403 vest in equal annual installments over a two-year period and 21,522 vest in equal annual installments over a four-year period. The Company recorded approximately \$1.0 million in compensation expense related to these restricted stock grants during the nine months ended September 30, 2004.

In May 2004, the Company's Compensation Committee granted an aggregate of 3,684 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, 1,842 vest at the end of a one-year period and 1,842 vest at the end of a two-year period.

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KILROY REALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Compensation expense for the restricted shares is calculated based on the closing per share price of \$32.59 on the May 18, 2004 grant date and is being amortized over the two-year vesting period. The Company recorded approximately \$22,000 related to these restricted stock grants during the nine months ended September 30, 2004.

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 shareholder returns on an absolute and relative basis. 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 period. 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%. Compensation expense under this program is accounted for using variable plan accounting. The Company estimates the amount to be paid based on the Company's closing stock price at the end of each 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 stock price, the total payable over the term of the plan changes by approximately \$1.7 million. During the nine months ended September 30, 2004 and 2003, the Company accrued approximately \$10.7 million and \$2.5 million, respectively, of compensation expense related to this plan. During the three months ended September 30, 2004 and 2003 the Company accrued approximately \$5.8 million and \$1.6 million, respectively, of compensation expense related to this plan. The total amount accrued relating to the plan was \$16.6 million as of September 30, 2004.

During the nine months ended September 30, 2004, the Company accepted the return, at the current quoted market price, of 36,955 shares of its common stock from certain key employees and one non-employee director 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.

8. Other Property Income

Under the terms of a previous tenant's plan of reorganization, the Company received shares of stock in the reorganized company in satisfaction of the Company's creditor's claim under the lease. This tenant had previously defaulted on its lease in 2001 and filed for bankruptcy in 2002. The Company recorded a net lease termination fee of approximately \$0.5 million in January 2004, representing the fair value of the stock on the date of receipt. During the first quarter of 2004, the Company sold all of the shares, in a series of open market transactions, at an additional net gain of approximately \$0.1 million. This gain is included in interest and other income on the Company's consolidated statement of operations for the nine months ended September 30, 2004.

During the third quarter of 2004, the Company recorded \$1.3 million of other property income related to a lease termination in 2001. This additional income had previously been reserved for financial reporting purposes until certain contingencies associated with the lease termination had been resolved.

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During the third quarter of 2004, the Company recorded a \$1.75 million charge in other property income in connection with the proposed settlement of outstanding litigation.

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KILROY REALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. Provision for Bad Debts

Peregrine Systems, Inc.

As previously reported, Peregrine Systems, Inc. (Peregrine) filed for bankruptcy in 2002 and early terminated leases it had with the Company. Under the terms of Peregrine s plan of reorganization and in accordance with a settlement agreement approved by the bankruptcy court, the Company received a payment of \$18.3 million in the third quarter of 2003 and was scheduled to receive four additional payments of approximately \$750,000 each to be paid annually over the next four years. The future payments were recorded at their net present value that was approximately \$2.6 million. The future payments were reserved for financial reporting purposes at December 31, 2003 through the provision for bad debts. During the third quarter of 2004 the Company reversed approximately \$750,000 of the provision due to the collection of the first of the four annual installment payments due under the settlement agreement.

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 administration, 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 corporate general and administrative expenses. There is no intersegment activity.

| | Three Months Ended | | Nine Months Ended | |
|---|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2004 | 2003 | 2004 | 2003 |
| | (in thousands) | | | |
| Office Properties: | | | | |
| Operating revenues(1) | \$45,276 | \$ 58,951 | \$ 133,679 | \$ 140,356 |
| Property and related expenses | 11,323 | 13,263 | 34,966 | 32,696 |
| Net operating income, as defined | 33,953 | 45,688 | 98,713 | 107,660 |
| Industrial Properties: | | | | |
| Operating revenues(1) | 8,722 | 8,982 | 26,203 | 26,998 |
| Property and related expenses | 1,123 | 1,189 | 3,505 | 3,306 |
| Net operating income, as defined | 7,599 | 7,793 | 22,698 | 23,692 |
| Total Reportable Segments: | | | | |
| Operating revenues(1) | 53,998 | 67,933 | 159,882 | 167,354 |
| Property and related expenses | 12,446 | 14,452 | 38,471 | 36,002 |
| Net operating income, as defined | 41,552 | 53,481 | 121,411 | 131,352 |
| Reconciliation to Consolidated Net Income: | | | | |
| Total net operating income, as defined, for reportable segments | 41,552 | 53,481 | 121,411 | 131,352 |
| Other unallocated revenues: | | | | |
| Interest and other income | 77 | 36 | 462 | 130 |
| Other unallocated expenses: | | | | |
| General and administrative expenses | 9,399 | 5,089 | 22,342 | 13,231 |

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| | | | | |
|---|-------------------|-------------------|-------------------|-------------------|
| Interest expense | 9,540 | 8,869 | 27,898 | 24,143 |
| Depreciation and amortization | 14,456 | 14,067 | 42,246 | 40,044 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Income from continuing operations before minority interests | 8,234 | 25,492 | 29,387 | 54,064 |
| Minority interests attributable to continuing operations | (2,968) | (6,306) | (9,881) | (15,970) |
| Income from discontinued operations | 5,876 | 853 | 7,043 | 6,231 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net income | 11,142 | 20,039 | 26,549 | 44,325 |
| Preferred dividends | (785) | | (2,355) | |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net income available to common shareholders | \$ 10,357 | \$ 20,039 | \$ 24,194 | \$ 44,325 |
| | <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 and the net gain or loss on dispositions of operating properties sold or classified as held for sale are reflected in the consolidated statement of operations as discontinued operations for all periods presented. For the three and nine months ended September 30, 2004 and 2003, discontinued operations included the net income, the impairment loss and the net gain or loss on sale of one office and one industrial property sold during the nine months ended September 30, 2004 (see Note 2) and the three office buildings and two industrial buildings sold or classified as held for sale during the six months ended June 30, 2005 (see Note 15). For the three and nine months ended September 30, 2003, discontinued operations also included the net income and net gain or loss on sale of the seven office buildings that the Company sold in 2003. In connection with the disposition of one of the buildings sold in 2003, the Company repaid approximately \$8.0 million in principal of a mortgage loan partially secured by the sold property. The related interest expense was allocated to discontinued operations. The following table summarizes the income and expense components that comprise discontinued operations for the three and nine months ended September 30:

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|---------------|-------------------|-----------------|
| | September 30, | | September 30, | |
| | 2004 | 2003 | 2004 | 2003 |
| | (in thousands) | | | |
| REVENUES: | | | | |
| Rental income | \$ 1,257 | \$ 1,957 | \$ 4,858 | \$ 7,415 |
| Tenant reimbursements | 157 | 172 | 534 | 738 |
| Other property income | | | 484 | 12 |
| Total revenues | 1,414 | 2,129 | 5,876 | 8,165 |
| EXPENSES: | | | | |
| Property expenses | 316 | 378 | 1,229 | 1,876 |
| Real estate taxes | 157 | 211 | 555 | 695 |
| Provision for bad debts | (2) | 14 | 43 | 92 |
| Interest expense | | | | 82 |
| Depreciation and amortization | 429 | 497 | 1,409 | 1,875 |
| Total expenses | 900 | 1,100 | 3,236 | 4,620 |
| Income from discontinued operations before minority interests | 514 | 1,029 | 2,640 | 3,545 |
| Net gain (loss) on disposition of discontinued operations | 6,212 | (48) | 6,148 | 3,642 |
| Impairment loss on property held for sale | | | (726) | |
| Minority interest in earnings of Operating Partnership attributable to discontinued operations | (850) | (128) | (1,019) | (956) |
| Total income from discontinued operations | \$ 5,876 | \$ 853 | \$ 7,043 | \$ 6,231 |

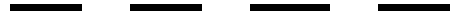


Table of Contents**KILROY REALTY CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****12. Earnings Per Share (As Restated, See Note 14)**

Basic earnings per share is computed by dividing net income by the weighted-average number of common shares outstanding for the period. Diluted earnings per share is computed by dividing net income 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.

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|------------|-------------------|------------|
| | September 30, | | September 30, | |
| | 2004 | 2003 | 2004 | 2003 |
| (in thousands, except share and per share amounts) | | | | |
| Numerator: | | | | |
| Income from continuing operations | \$ 5,266 | \$ 19,186 | \$ 19,506 | \$ 38,094 |
| Preferred dividends | (785) | | (2,355) | |
| Income from continuing operations available for common stockholders | 4,481 | 19,186 | 17,151 | 38,094 |
| Discontinued operations | 5,876 | 853 | 7,043 | 6,231 |
| Net income available for common stockholders numerator for basic and diluted earnings per share | \$ 10,357 | \$ 20,039 | \$ 24,194 | \$ 44,325 |
| Denominator: | | | | |
| Basic weighted-average shares outstanding | 28,271,214 | 27,584,345 | 28,202,925 | 27,386,930 |
| Effect of dilutive securities-stock options and restricted stock | 168,451 | 216,197 | 165,580 | 206,196 |
| Diluted weighted-average shares and common share equivalents outstanding | 28,439,665 | 27,800,542 | 28,368,505 | 27,593,126 |
| Basic earnings per share: | | | | |
| Income from continuing operations available for common stockholders (As Restated, see Note 14) | \$ 0.16 | \$ 0.70 | \$ 0.61 | \$ 1.39 |
| Discontinued operations | 0.21 | 0.03 | 0.25 | 0.23 |
| Net income available for common stockholders | \$ 0.37 | \$ 0.73 | \$ 0.86 | \$ 1.62 |

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Diluted earnings per share:

| | | | | |
|--|----------------|----------------|----------------|----------------|
| Income from continuing operations available for common stockholders (As Restated, see Note 14) | \$ 0.16 | \$ 0.69 | \$ 0.60 | \$ 1.38 |
| Discontinued operations | 0.20 | 0.03 | 0.25 | 0.23 |
| Income available for common stockholders | <u>\$ 0.36</u> | <u>\$ 0.72</u> | <u>\$ 0.85</u> | <u>\$ 1.61</u> |

At September 30, 2004, Company employees and directors did not hold any options to purchase shares of the Company's common stock that were antidilutive to the diluted earnings per share computation.

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On October 15, 2004, aggregate distributions of approximately \$16.1 million were paid to common stockholders and common unitholders of record on September 30, 2004.

On October 22, 2004, the Company obtained a \$425 million unsecured revolving credit facility to replace the Credit Facility that was scheduled to mature in March 2005 (see Note 4).

14. Restatements*Income from Continuing Operations per Common Share*

Subsequent to the issuance of the Company's quarterly financial statements for the three and nine months ended September 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. The calculation error had no impact on income from continuing operations, net income, net income per share, or the Company's consolidated balance sheets, consolidated statement of stockholders' equity and consolidated statements of cash flows. The only line items required to be restated to correct this calculation error are the per share amounts for income from continuing operations, basic and diluted, included within the consolidated statements of operations. As a result, Income from continuing operations per common share - basic and diluted - for the three and nine months ended September 30, 2004 included within the consolidated statements of operations and in Note 12 to the consolidated financial statements have been restated from the amounts previously reported.

| | Three Months Ended September 30, 2004 | | | |
|--|--|--|--|---|
| | As Previously Reported | Restatements: Preferred Dividends | Reclassifications: Subsequent Dispositions(1) | As Restated and Reclassified |
| Basic earnings per share: | | | | |
| Income from continuing operations per common share | \$ 0.19 | \$ (0.03) | \$ | \$ 0.16 |
| Diluted earnings per share: | | | | |
| Income from continuing operations per common share | \$ 0.19 | \$ (0.03) | \$ | \$ 0.16 |

Three Months Ended September 30, 2003

| | <u>As Previously Reported</u> | <u>Restatements: Preferred Dividends</u> | <u>Reclassifications: Subsequent Dispositions(1)</u> | <u>As Restated and Reclassified</u> |
|--|---------------------------------------|--|--|---|
| Basic earnings per share: | | | | |
| Income from continuing operations per common share | \$ 0.71 | \$ | \$ (0.01) | \$ 0.70 |
| Diluted earnings per share: | | | | |
| Income from continuing operations per common share | \$ 0.70 | \$ | \$ (0.01) | \$ 0.69 |

(1) Includes the discontinued operations that have resulted from the disposition of the four operating properties that were sold subsequent to September 30, 2004 and the classification of a property as held for sale as of June 30, 2005.

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KILROY REALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

| | Nine Months Ended September 30, 2004 | | | |
|--|--------------------------------------|---|---|---------------------------------------|
| | As Previously Reported | Restatements: Preferred Dividends | Reclassifications: Subsequent Dispositions(1) | As Restated and Reclassified |
| Basic earnings per share: | | | | |
| Income from continuing operations per common share | \$ 0.73 | \$ (0.08) | \$ (0.04) | \$ 0.61 |
| Diluted earnings per share: | | | | |
| Income from continuing operations per common share | \$ 0.73 | \$ (0.08) | \$ (0.05) | \$ 0.60 |
| | Nine Months Ended September 30, 2003 | | | |
| | As Previously Reported | Restatements: Preferred Dividends | Reclassifications: Subsequent Dispositions(1) | As Restated and Reclassified |
| Basic earnings per share: | | | | |
| Income from continuing operations per common share | \$ 1.42 | \$ | \$ (0.03) | \$ 1.39 |
| Diluted earnings per share: | | | | |
| Income from continuing operations per common share | \$ 1.40 | \$ | \$ (0.02) | \$ 1.38 |

(1) Includes the discontinued operations that have resulted from the disposition of the four operating properties that were sold subsequent to September 30, 2004 and the classification of a property as held for sale as of June 30, 2005.

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

Also subsequent to the issuance of the Company's quarterly financial statements for the nine months ended September 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 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 consolidated 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 nine months ended September 30, 2004 and 2003 included in the consolidated statements of cash flows have been restated from the amounts previously reported. In addition, the Company reclassified the change in restricted cash 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.

| | Nine Months Ended September 30, | | | |
|---|---------------------------------|-------------|-------------|-------------|
| | 2004 | | 2003 | |
| | As Reported | As Restated | As Reported | As Restated |
| | (in thousands) | | | |
| Net cash provided by operating activities | \$ 77,868 | \$ 84,364 | \$ 82,341 | \$ 97,718 |
| Net cash used in investing activities | \$ (9,786) | \$ (1,553) | \$ (30,797) | \$ (38,032) |
| Net cash used in financing activities | \$ (74,322) | \$ (89,051) | \$ (51,243) | \$ (59,385) |

15. Subsequent Dispositions

Subsequent to the quarter ended September 30, 2004 the Company sold the following five operating properties. The property that was sold in July 2005 was classified as held for sale as of June 30, 2005.

| Address/City | Property Type | Month of Disposition | Number of Buildings | Rentable Square Feet |
|---|---------------|----------------------|---------------------|----------------------|
| 2501 Pullman/1700 Carnegie, Santa Ana, CA | Office | March | 2 | 128,266 |

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| | | | | |
|--|------------|-------|---|---------|
| 525 North Brand, Glendale, CA | Office | March | 1 | 46,043 |
| 5115 North 27th Avenue, Phoenix, AZ | Industrial | March | 1 | 130,877 |
| 2260 E. El Segundo Boulevard, El Segundo, CA | Industrial | July | 1 | 113,820 |
| | | | 5 | 419,006 |
| Total | | | 5 | 419,006 |

The Company has updated its historical consolidated financial statements in this Form 10-Q/A for discontinued operations that have resulted from the disposition of four operating properties during the six months ended June 30, 2005 and the classification of the property as held for sale as of June 30, 2005 in accordance with Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144). The net income for these properties has been reclassified to discontinued operations for the three and nine months ended September 30, 2004 and 2003 to conform to the presentation in the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2005.

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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 for the year ended December 31, 2003 and under the captions Factors That May Influence Future Results of Operations and

Liquidity and Capital Resources Factors That May Influence Future Sources of Capital and Liquidity below. In light of these risks, uncertainties and assumptions, the forward-looking events contained 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 statements of cash flows and the reclassifications for discontinued operations. For a more detailed description of the restatements and reclassifications, see Notes 14 and 15 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 87.7% and 86.9% general partnership interest in the Operating Partnership as of September 30, 2004 and 2003, respectively.

As of September 30, 2004, the Company's stabilized portfolio was comprised of 82 office properties (the Office Properties) encompassing an aggregate of approximately 7.4 million rentable square feet, and 49 industrial properties (the Industrial Properties, and together with the Office Properties, the Properties), encompassing an aggregate of approximately 4.6 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.

Factors That May Influence Future Results of Operations

Rental income. The amount of net rental income generated by the Properties depends principally on the Company's 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

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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 September 30, 2004, the change in rental rate was a decrease of 13.0% on a GAAP basis, and a decrease of 21.2% on a cash basis. The change in rental rates for leases that commenced during the nine months ended September 30, 2004 was a decrease of 6.1% on a GAAP basis, and a decrease of 13.4% 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 change in rental rates on a GAAP basis for the quarter and year to date is primarily due to one lease the Company renewed with The Boeing Company with a decrease in rental rate of 25% on both a GAAP and cash basis. See additional discussion of The Boeing Company under Recent information regarding significant tenants. Excluding this lease, the change in rental rates on a GAAP basis would have been an increase of 9.4% for the quarter and 8.5% year to date. The change in rental rates on a cash basis would have been a decrease of 12.4% for the quarter and 4.2% year to date. Management believes that the average rental rates for its Properties generally are between market and 5% above 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 830,900 square feet of currently available space in the Company's stabilized portfolio, leases representing approximately 0.9% and 12.6% of the leased square footage of the Company's stabilized portfolio are scheduled to expire during the remainder of 2004 and in 2005, respectively. The leases scheduled to expire during the remainder of 2004 and the leases scheduled to expire in 2005 represent approximately 0.7 million square feet of office space, or 7.1% of the Company's total annualized base rent, and 0.8 million square feet of industrial space, or 2.9% of the Company's total annualized base rent, respectively. The Company's ability to release available space depends upon the market conditions in the specific submarkets in which the Properties are located.

Los Angeles County submarket information. There have been modest signs of improvement in market conditions in the Los Angeles County submarket during the last five quarters based on 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. At September 30, 2004, the Company's Los Angeles stabilized office portfolio was 89% occupied with approximately 305,100 vacant rentable square feet as compared to 83% occupied with approximately 563,200 vacant rentable square feet at December 31, 2003. As of September 30, 2004, leases representing an aggregate of approximately 35,600 and 140,100 rentable square feet are scheduled to expire during the remainder of 2004 and in 2005, respectively, in this submarket.

The Los Angeles stabilized portfolio includes two office buildings that were developed by the company, encompassing approximately 284,300 rentable square feet. These buildings were previously in the lease-up phase and were added to the stabilized portfolio during 2003, since one year had passed following substantial completion. One of the buildings is located in West Los Angeles. This building encompasses approximately 151,000 rentable square feet and was 64% occupied as of September 30, 2004. As of September 30, 2004, the Company had executed leases for 95% of the rentable square feet at this building compared to 61% as of December 31, 2003.

The other stabilized office building is located in a two-building complex in the El Segundo submarket. This building encompasses approximately 133,300 rentable square feet and was approximately 32% occupied as of September 30, 2004. The Company had executed leases or letters of intent for 56% of the rentable square feet at this building as of September 30, 2004, compared to 31% as of December 31, 2003. Within the same complex in El Segundo, the Company had one office redevelopment project encompassing approximately 241,600 rentable

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square feet. This project was in the lease-up phase as of September 30, 2004 and was 19% leased as of September 30, 2004. Although management has seen increased activity and modest signs of improvement, the El Segundo submarket remains the Company's most significant leasing challenge.

San Diego County submarket information. As of September 30, 2004, the Company's San Diego stabilized office portfolio was 96% occupied with approximately 116,700 vacant rentable square feet. This includes one office development project, encompassing approximately 208,500 rentable square feet, that was previously in the lease-up phase and added to the stabilized portfolio during the quarter ended September 30, 2004 since it had been one year following substantial completion. As of September 30, 2004, this building was 84% occupied, and the Company has executed leases for 100% of the rentable square feet. In January 2004, the Company completed the redevelopment of one office building in the San Diego region, encompassing approximately 68,000 rentable square feet. The Company also commenced construction on the third phase of a development project in July 2004. These development and redevelopment projects were not leased as of September 30, 2004. Further, leases representing an aggregate of approximately 25,100 and 288,700 rentable square feet were scheduled to expire during the remainder of 2004 and in 2005, respectively, in this submarket. See additional information regarding the Company's development projects under the caption Development and redevelopment programs below.

Orange County submarket information. As of September 30, 2004, the Company's Orange County properties were 97% occupied with approximately 144,300 vacant rentable square feet. As of September 30, 2004, leases representing an aggregate of approximately 22,200 and 660,900 rentable square feet were scheduled to expire during the remainder of 2004 and in 2005, respectively, in this submarket.

Sublease space. Of the Company's leased space at September 30, 2004, approximately 424,500 rentable square feet, or 3.5%, of the square footage in the Company's stabilized portfolio was available for sublease, of which approximately 3.0% was vacant space and the remaining 0.5% was occupied. Of the approximately 424,500 rentable square feet available for sublease, approximately 39,400 rentable square feet represents leases scheduled to expire during the remainder of 2004 and in 2005.

Negative trends or other events that impair the Company's ability to renew or release 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. As of September 30, 2004, the Company's largest tenant, The Boeing Company, leased an aggregate of approximately 839,100 rentable square feet of office space under eight separate leases, representing approximately 6.3% of the Company's total annual base rental revenues. In April 2004, the Boeing Company renewed one lease for a building located in El Segundo, encompassing approximately 286,200 rentable square feet, which was scheduled to expire in July 2004. Under the terms of the amended lease, the rental rate decreased 25% on a cash and GAAP basis and the lease is now scheduled to expire in July 2007. One lease encompassing approximately 211,100 rental 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 either December 31, 2005 or December 31, 2006 by giving the Company written notice one year in advance. Another lease encompassing approximately 7,800 rentable square feet is scheduled to expire in November 2004. The other five leases are scheduled to expire at various dates between August 2005 and March 2009.

Development and redevelopment programs. Management believes that a portion of the Company's potential growth over the next several years will continue to come from its development pipeline. During 2003 and 2002, 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.

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However, in response to signs of improvement in the San Diego office market, the Company commenced construction in July 2004 on the third phase of its Innovation Corporate Center, which is located in the Rancho Bernardo submarket. The first two phases of the development project are 100% leased and encompass an aggregate of approximately 289,000 rentable square feet. The third phase will include two office buildings and will encompass an aggregate of approximately 103,000 rentable square feet and has a total estimated investment

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of approximately \$22.8 million. The Company does not have any lease commitments for these buildings as of the date of this report, but management was comfortable commencing construction given the current level of tenant demand in this submarket.

The Company also owns approximately 52.8 acres of undeveloped land 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.

Management believes that another source of the Company's potential growth over the next several years will come from 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 includes one life science conversion project in North San Diego County and another project in which the Company performed extensive interior refurbishments at an office building in El Segundo that had been occupied by a single tenant for approximately 30 years. These projects, which encompass approximately 309,600 rentable square feet, were completed in 2004 and are expected to be added to the stabilized portfolio in the first and third quarters of 2005. These projects were 15% leased as of September 30, 2004. 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 94.5% 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% during 2002, approximately 11% during 2003 and approximately 11% year to date in 2004. As of the date of this report, the Company had not experienced any material negative effects arising from either of these issues.

Although the Company has been able to mitigate the impact of tenant defaults on its financial condition, revenues and results of operations, the Company's financial condition, results of operations and cash flows would be adversely affected if any of the Company's significant tenants fail to renew their leases, renew their leases on terms less favorable to the Company or if any of them become bankrupt or insolvent or otherwise unable to satisfy their lease obligations.

Incentive Compensation. The Company has long-term incentive compensation programs that provide for cash and stock compensation to be earned by the Company's executive officers if the Company attains certain performance measures that are based on annualized shareholder 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 closing price per share of the Company's common stock at the end of each quarter. Potential future increases in the price per share of the Company's common stock and the effect on cumulative annualized shareholder return calculations will cause an increase to general and administrative expenses attributable to compensation expense and a corresponding decrease to net income available to common shareholders. Management cannot predict the amounts that will be ultimately recorded in future periods related to these plans since they are significantly influenced by the Company's stock price and market conditions.

Table of Contents**Results of Operations**

The following table reconciles the changes in the rentable square feet in the Company's stabilized portfolio of operating properties from September 30, 2003 to September 30, 2004. Rentable square footage in the Company's portfolio of stabilized properties decreased by an aggregate of approximately 0.2 million rentable square feet, or 1.6%, to 12.0 million rentable square feet at September 30, 2004, compared to 12.2 million rentable square feet at September 30, 2003 as a result of properties sold subsequent to September 30, 2003, net of the development projects completed and added to the Company's stabilized portfolio of operating properties subsequent to September 30, 2003.

As of September 30, 2004, the Office and Industrial Properties represented 83.9% and 16.1%, respectively, of the Company's annualized base rent. For the three months ended September 30, 2004, average occupancy in the Company's stabilized portfolio was 93.2% compared to 90.2% for the three months ended September 30, 2003. As of September 30, 2004, the Company had approximately 830,900 rentable square feet of vacant space in its stabilized portfolio compared to 1,241,200 rentable square feet as of September 30, 2003.

| | Office Properties | | Industrial Properties | | Total | |
|---|---------------------|------------------|-----------------------|------------------|---------------------|-------------------|
| | Number of Buildings | Square Feet | Number of Buildings | Square Feet | Number of Buildings | Square Feet |
| Total at September 30, 2003 | 82 | 7,317,574 | 50 | 4,877,213 | 132 | 12,194,787 |
| Properties added from the Development Portfolio | 1 | 208,464 | | | 1 | 208,464 |
| Dispositions(1) | (1) | (124,986) | (1) | (277,037) | (2) | (402,023) |
| Remeasurement | | (8,458) | | 1,391 | | (7,067) |
| Total at September 30, 2004(2) | 82 | 7,392,594 | 49 | 4,601,567 | 131 | 11,994,161 |

(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 are included in discontinued operations in the consolidated statements of operations.

(2) Includes three office buildings and one industrial building the Company sold as of June 30, 2005, which encompassed approximately 305,200 rentable square feet. Also includes one industrial building classified as held for sale as of June 30, 2005, which encompassed approximately 113,800 rentable square feet.

Table of Contents**Comparison of the Three Months Ended September 30, 2004 to the Three Months Ended September 30, 2003**

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 for the three months ended September 30, 2004 and 2003.

| | Three Months | | Dollar Change | Percentage Change |
|--|---------------|-----------|------------------|----------------------|
| | Ended | | | |
| | September 30, | | | |
| | 2004 | 2003 | | |
| (in thousands) | | | | |
| Net Operating Income, as defined: | | | | |
| Office Properties | \$ 33,953 | \$ 45,688 | \$ (11,735) | (25.7)% |
| Industrial Properties | 7,599 | 7,793 | (194) | (2.5) |
| Total portfolio | 41,552 | 53,481 | (11,929) | (22.3) |
| Reconciliation to Consolidated Net Income: | | | | |
| Net Operating Income, as defined for reportable segments | 41,552 | 53,481 | (11,929) | (22.3) |
| Other expenses: | | | | |
| General and administrative expenses | 9,399 | 5,089 | 4,310 | 84.7 |
| Interest expense | 9,540 | 8,869 | 671 | 7.6 |
| Depreciation and amortization | 14,456 | 14,067 | 389 | 2.8 |
| Interest and other income | 77 | 36 | 41 | 113.9 |
| Income from continuing operations before minority interest | 8,234 | 25,492 | (17,258) | (67.7) |
| Minority interests attributable to continuing operations | (2,968) | (6,306) | 3,338 | (52.9) |
| Income from discontinued operations | 5,876 | 853 | 5,023 | 588.9 |
| Net income | 11,142 | 20,039 | (8,897) | (44.4) |
| Preferred dividends | (785) | | (785) | (100.0) |
| Net income available to common shareholders | \$ 10,357 | \$ 20,039 | \$ (9,682) | (48.3)% |

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Management evaluates the operations of its portfolio based on operating property type. The following tables compare the net operating income for the Office Properties and for the Industrial Properties for the three months ended September 30, 2004 and 2003.

Office Properties

| | Total Office Portfolio | | | | Core Office Portfolio(1) | | | |
|---|------------------------|------------------|--------------------|-------------------|--------------------------|------------------|--------------------|-------------------|
| | 2004 | 2003 | Dollar Change | Percentage Change | 2004 | 2003 | Dollar Change | Percentage Change |
| (in thousands) | | | | | | | | |
| Operating revenues: | | | | | | | | |
| Rental income | \$ 41,699 | \$ 37,060 | \$ 4,639 | 12.5% | \$ 36,095 | \$ 33,704 | \$ 2,391 | 7.1% |
| Tenant reimbursements | 3,852 | 3,465 | 387 | 11.2 | 3,751 | 3,524 | 227 | 6.4 |
| Other property income | (275) | 18,426 | (18,701) | (101.5) | (277) | 18,424 | (18,701) | (101.5) |
| Total | 45,276 | 58,951 | (13,675) | (23.2) | 39,569 | 55,652 | (16,083) | (28.9) |
| Property and related expenses: | | | | | | | | |
| Property expenses | 7,929 | 7,213 | 716 | 9.9 | 7,070 | 6,480 | 590 | 9.1 |
| Real estate taxes | 3,583 | 3,044 | 539 | 17.7 | 2,962 | 2,824 | 138 | 4.9 |
| Provision for bad debts | (523) | 2,680 | (3,203) | (119.5) | (420) | 2,617 | (3,037) | (116.0) |
| Ground leases | 334 | 326 | 8 | 2.5 | 334 | 326 | 8 | 2.5 |
| Total | 11,323 | 13,263 | (1,940) | (14.6) | 9,946 | 12,247 | (2,301) | (18.8) |
| Net operating income, as defined | \$ 33,953 | \$ 45,688 | \$ (11,735) | (25.7)% | \$ 29,623 | \$ 43,405 | \$ (13,782) | (31.8)% |

(1) Office properties owned and stabilized at January 1, 2003 and still owned and stabilized at June 30, 2005.

Total revenues from Office Properties decreased \$13.7 million, or 23.2%, to \$45.3 million for the three months ended September 30, 2004 compared to \$59.0 million for the three months ended September 30, 2003. Rental income from Office Properties increased \$4.6 million, or 12.5%, to \$41.7 million for the three months ended September 30, 2004 compared to \$37.1 million for the three months ended September 30, 2003. Rental income generated by the Core Office Portfolio increased \$2.4 million, or 7.1%, for the three months ended September 30, 2004 as compared to the three months ended September 30, 2003. This increase is primarily due to an increase in occupancy in this portfolio. Average occupancy in the Core Office Portfolio increased 4.4% to 95.1% for the three months ended September 30, 2004 compared to 90.7% for the same period in 2003. The remaining \$2.2 million increase in rental income was attributable to a \$1.7 million increase in rental income generated by the office properties developed by the Company in 2003 and 2004 (the Office Development Properties) and a \$0.5 million increase in rental income generated by the office properties that the Company redeveloped during the first quarter of 2003 and the second quarter of 2004 (the Office Redevelopment Properties).

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Tenant reimbursements from Office Properties increased \$0.4 million, or 11.2%, to \$3.9 million for the three months ended September 30, 2004 compared to \$3.5 million for the three months ended September 30, 2003. Of this increase, \$0.2 million was generated by the Core Office Portfolio and the remaining \$0.2 million was mainly attributable to the Office Redevelopment Properties. The increase from the Core Office Portfolio is primarily attributable to an increase in occupancy in this portfolio, as noted above. Other property income from Office Properties decreased approximately \$18.7 million, or 101.5%, to a \$0.3 million charge for the three

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months ended September 30, 2004 compared to \$18.4 million for the three months ended September 30, 2003. Other Property Income for the three months ended September 30, 2003 included an \$18.0 million lease termination fee related to a settlement with Peregrine Systems Inc. In accordance with the settlement agreement approved by the bankruptcy court, the Company received a payment of \$18.3 million in 2003 and was scheduled to receive four additional payments of approximately \$750,000 each to be paid annually over the next four years. The future payments were recorded at their net present value which was approximately \$2.6 million. The lease termination fee of \$18.0 represents the \$18.3 million payment plus the \$2.6 million net present value of the future payments, offset by \$2.9 million in receivables and other costs and obligations associated with the leases. The future payments were reserved for financial reporting purposes at September 30, 2003 through the provision for bad debts. Other Property Income for the three months ended September 30, 2004 included a \$1.8 million charge related to a proposed settlement for outstanding litigation. This charge was partially offset by \$1.3 million of other income related to a lease termination in 2001. This additional income had previously been reserved for financial reporting purposes until certain contingencies associated with the lease termination had been resolved.

Total expenses from Office Properties decreased \$1.9 million, or 14.6%, to \$11.3 million for the three months ended September 30, 2004 compared to \$13.2 million for the three months ended September 30, 2003. Property expenses from Office Properties increased \$0.7 million, or 9.9%, to \$7.9 million for the three months ended September 30, 2004 compared to \$7.2 million for the three months ended September 30, 2003. An increase of \$0.6 million, or 9.1%, was generated by the Core Office Portfolio. This increase was primarily attributable to an increase in property management expenses, janitorial and other contract services related to the increase in occupancy. The remaining \$0.1 million increase in property expenses was attributable to a \$0.2 million increase in the Office Development Properties, partially offset by a \$0.1 million decrease related to the Office Redevelopment Properties. Real estate taxes from Office Properties increased \$0.5 million, or 17.7%, for the three months ended September 30, 2004 as compared to the same period in 2003. Real estate taxes for the Core Office Portfolio increased \$0.1 million, or 4.9%, for the three months ended September 30, 2004 compared to the three months ended September 30, 2003. The remaining \$0.4 million increase in real estate taxes was due to a \$0.3 million increase related to the Office Redevelopment Properties and a \$0.1 million increase in the Office Development Properties. The increase in real estate taxes attributable to the Office Redevelopment Properties is due to the reassessment of the improvements added during the redevelopment of the projects. The provision for bad debts from Office Properties decreased \$3.2 million, or 119.5%, for the three months ended September 30, 2004 compared to the three months ended September 30, 2003. The decrease was primarily due to a decrease in the provision related to the Company's leases with Peregrine. During the three months ended September 30, 2003 the Company recorded a \$2.6 million provision to reserve for future payments due under the Peregrine Settlement Agreement as discussed in the preceding paragraph. During the three months ended September 30, 2004 the Company reversed \$0.8 million of the provision due to the collection of the first of four annual installment payments due under the settlement agreement. The Company evaluates its reserve levels on a quarterly basis. Ground lease expense for Office Properties remained consistent at approximately \$0.3 million for the three months ended September 30, 2004 compared to the same period in 2003.

Net operating income, as defined, from Office Properties decreased \$11.7 million, or 25.7%, to \$34.0 million for the three months ended September 30, 2004 compared to \$45.7 million for the three months ended September 30, 2003. Net operating income from the Core Office Portfolio decreased by \$13.8 million, which was primarily due to the Peregrine lease termination fee recorded during the three months ended September 30, 2003. An increase of \$2.1 million in net operating income was due to \$1.6 million generated by the Office Development Properties and \$0.5 million generated by the Office Redevelopment Properties.

Table of Contents**Industrial Properties**

| | Total Industrial Portfolio(1) | | | |
|---|--------------------------------------|-----------------|--------------------------|------------------------------|
| | 2004 | 2003 | Dollar Change | Percentage Change |
| | (in thousands) | | | |
| Operating revenues: | | | | |
| Rental income | \$ 7,855 | \$ 8,052 | \$ (197) | (2.4)% |
| Tenant reimbursements | 865 | 915 | (50) | (5.5) |
| Other property income | 2 | 15 | (13) | (86.7) |
| Total | 8,722 | 8,982 | (260) | (2.9) |
| Property and related expenses: | | | | |
| Property expenses | 410 | 431 | (21) | (4.9) |
| Real estate taxes | 712 | 705 | 7 | 1.0 |
| Provision for bad debts | 1 | 53 | (52) | (98.1) |
| Total | 1,123 | 1,189 | (66) | (5.6) |
| Net operating income, as defined | \$ 7,599 | \$ 7,793 | \$ (194) | (2.5)% |

(1) The Total Industrial Portfolio is equivalent to the Company's Core Industrial Portfolio at September 30, 2004, which represents properties owned and stabilized at January 1, 2003 and still owned and stabilized at June 30, 2005, excluding the building classified as held for sale as of June 30, 2005.

Total revenues from Industrial Properties decreased \$0.3 million, or 2.9%, to \$8.7 million for the three months ended September 30, 2004 compared to \$9.0 million for the three months ended September 30, 2003. Rental income from Industrial Properties decreased \$0.2 million, or 2.4%, to \$7.9 million for the three months ended September 30, 2004 compared to \$8.1 million for the three months ended September 30, 2003. This decrease was primarily due to a decline in occupancy. Average occupancy in the industrial portfolio decreased 1.6% to 94.2% at September 30, 2004 compared to 95.8% at September 30, 2003.

Tenant reimbursements from Industrial Properties remained consistent at \$0.9 million for the three months ended September 30, 2004 compared to the three months ended September 30, 2003. Other property income from Industrial Properties remained consistent during the three months ended September 30, 2004 compared to the three months ended September 30, 2003.

Total expenses from Industrial Properties decreased \$0.1 million, or 5.6%, to \$1.1 million for the three months ended September 30, 2004 compared to \$1.2 million for the three months ended September 30, 2003. Property expenses from Industrial Properties remained consistent at \$0.4 million for the three months ended September 30, 2004 compared to the three months ended September 30, 2003. Real estate taxes from Industrial Properties remained consistent at approximately \$0.7 million during the three months ended September 30, 2004 compared to the same period in 2003. The provision for bad debts decreased by \$0.1 million for the three months ended September 30, 2004 as compared to the three months ended September 30, 2003. The Company evaluates its reserve levels on a quarterly basis.

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Net operating income, as defined, from Industrial Properties decreased \$0.2 million, or 2.5%, to \$7.6 million for the three months ended September 30, 2004 compared to \$7.8 million for the three months ended September 30, 2003.

Non-Property Related Income and Expenses

General and administrative expenses increased \$4.3 million, or 84.7%, to \$9.4 million for the three months ended September 30, 2004 compared to \$5.1 million for the three months ended September 30, 2003. The increase was primarily due to a \$4.2 million increase in accrued incentive compensation and was driven by a

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special long-term incentive plan for the Company's executives for which the amount payable under the plan is based on the Company's absolute and relative shareholder returns (see Note 7 to the Company's consolidated financial statements for further discussion about the program). The plan is accounted for using variable plan accounting, which requires the Company to record the cumulative charge to the income statement based on the closing quoted price per share for the Company's common stock for the period. The closing price per share for the Company's common stock as of September 30, 2004 was \$38.03 compared to \$28.55 as of September 30, 2003. The amounts recorded in future periods related to this plan will increase and decrease as the Company's closing quarterly share price increases and decreases.

Net interest expense increased \$0.6 million, or 7.6%, to \$9.5 million for the three months ended September 30, 2004 compared to \$8.9 million for the three months ended September 30, 2003. Gross interest and loan fee expense, before the effect of capitalized interest and loan fees increased \$0.4 million, or 3.9%, to \$11.8 million for the three months ended September 30, 2004 compared to \$11.4 million for the three months ended September 30, 2003. Total capitalized interest and loan fees decreased \$0.2 million, or 9.1%, to \$2.3 million for the three months ended September 30, 2004 compared to \$2.5 million for the three months ended September 30, 2003, due to lower construction in progress balances eligible for capitalization during the three months ended September 30, 2004 compared to the three months ended September 30, 2003.

Depreciation and amortization increased \$0.4 million, or 2.8%, to \$14.5 million for the three months ended September 30, 2004 compared to \$14.1 million for the three months ended September 30, 2003. The increase was primarily attributable to an increase of \$0.6 million in the Office Development Properties partially offset by a decrease of \$0.2 million attributable to the Office Redevelopment Properties taken out of service in 2003.

Comparison of the Nine Months Ended September 30, 2004 to the Nine Months Ended September 30, 2003

The following table reconciles the Company's Net Operating Income by segment to the Company's net income for the nine months ended September 30, 2004 and 2003.

| | Nine Months | | Dollar Change | Percentage Change |
|--|----------------|----------------|------------------|----------------------|
| | Ended | | | |
| | September 30, | | | |
| | 2004 | 2003 | | |
| | (in thousands) | | | |
| Net Operating Income, as defined: | | | | |
| Office Properties | \$ 98,713 | \$ 107,660 | \$ (8,947) | (8.3)% |
| Industrial Properties | 22,698 | 23,692 | (994) | (4.2) |
| Total portfolio | 121,411 | 131,352 | (9,941) | (7.6) |
| Reconciliation to Consolidated Net Income: | | | | |
| Net Operating Income, as defined for reportable segments | 121,411 | 131,352 | (9,941) | (7.6) |
| Other expenses: | | | | |
| General and administrative expenses | 22,342 | 13,231 | 9,111 | 68.9 |
| Interest expense | 27,898 | 24,143 | 3,755 | 15.6 |
| Depreciation and amortization | 42,246 | 40,044 | 2,202 | 5.5 |

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| | | | | |
|--|-----------|-----------|-------------|---------|
| Interest and other income | 462 | 130 | 332 | 255.4 |
| Income from continuing operations before minority interest | 29,387 | 54,064 | (24,677) | (45.6) |
| Minority interests attributable to continuing operations | (9,881) | (15,970) | 6,089 | (38.1) |
| Income from discontinued operations | 7,043 | 6,231 | 812 | 13.0 |
| Net income | 26,549 | 44,325 | (17,776) | (40.1) |
| Preferred dividends | (2,355) | | (2,355) | (100.0) |
| Net income available to common shareholders | \$ 24,194 | \$ 44,325 | \$ (20,131) | (45.4)% |

Table of Contents**Rental Operations**

Management evaluates the operations of its portfolio based on operating property type. The following tables compare the net operating income for the Office Properties and for the Industrial Properties for the nine months ended September 30, 2004 and 2003.

Office Properties

| | Total Office Portfolio | | | | Core Office Portfolio(1) | | | |
|---|------------------------|-------------------|-------------------|-------------------|--------------------------|------------------|-------------------|-------------------|
| | 2004 | 2003 | Dollar Change | Percentage Change | 2004 | 2003 | Dollar Change | Percentage Change |
| (in thousands) | | | | | | | | |
| Operating revenues: | | | | | | | | |
| Rental income | \$ 120,828 | \$ 105,215 | \$ 15,613 | 14.8% | \$ 105,972 | \$ 97,856 | \$ 8,116 | 8.3% |
| Tenant reimbursements | 12,473 | 11,972 | 501 | 4.2 | 12,246 | 11,398 | 848 | 7.4 |
| Other property income | 378 | 23,169 | (22,791) | (98.4) | 354 | 18,897 | (18,543) | (98.1) |
| Total | 133,679 | 140,356 | (6,677) | (4.8) | 118,572 | 128,151 | (9,579) | (7.5) |
| Property and related expenses: | | | | | | | | |
| Property expenses | 23,755 | 21,404 | 2,351 | 11.0 | 21,112 | 19,849 | 1,263 | 6.4 |
| Real estate taxes | 10,151 | 8,974 | 1,177 | 13.1 | 8,665 | 8,331 | 334 | 4.0 |
| Provision for bad debts | 64 | 1,348 | (1,284) | (95.3) | (69) | 1,883 | (1,952) | (103.7) |
| Ground leases | 996 | 970 | 26 | 2.7 | 996 | 956 | 40 | 4.2 |
| Total | 34,966 | 32,696 | 2,270 | 6.9 | 30,704 | 31,019 | (315) | (1.0) |
| Net operating income, as defined | \$ 98,713 | \$ 107,660 | \$ (8,947) | (8.3)% | \$ 87,868 | \$ 97,132 | \$ (9,264) | (9.5)% |

(1) Office properties owned and stabilized at January 1, 2003 and still owned and stabilized at June 30, 2005.

Total revenues from Office Properties decreased \$6.7 million, or 4.8%, to \$133.7 million for the nine months ended September 30, 2004 compared to \$140.4 million for the nine months ended September 30, 2003. Rental income from Office Properties increased \$15.6 million, or 14.8%, to \$120.8 million for the nine months ended September 30, 2004 compared to \$105.2 million for the nine months ended September 30, 2003. Rental income generated by the Core Office Portfolio increased \$8.1 million, or 8.3%, for the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003. This increase is primarily due to an increase in occupancy in this portfolio. Average occupancy in the Core Office Portfolio increased 3.7% to 93.0% for the nine months ended September 30, 2004 compared to 89.3% for the same period in 2003. The remaining \$7.5 million increase was attributable to a \$8.5 million increase in rental income generated by the office properties developed by the Company in 2003 and 2004 (the Office Development Properties) which was offset by a decrease of \$1.0 million attributable to the office properties that were taken out of service and moved from the Company's stabilized portfolio to the redevelopment portfolio during the first quarter of 2003 and the second quarter of 2004 (the Office Redevelopment Properties).

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Tenant reimbursements from Office Properties increased \$0.5 million, or 4.2%, to \$12.5 million for the nine months ended September 30, 2004 compared to \$12.0 million for the nine months ended September 30, 2003. Tenant reimbursements generated by the Core Office Portfolio increased \$0.8 million, or 7.4%, for the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003. This increase is

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primarily attributable to both the reimbursement of prior year supplemental property taxes and the increase in occupancy in the Core Office Portfolio, as noted above. A decrease of \$0.3 million in tenant reimbursements is attributable to a decrease of \$0.4 million in the Office Redevelopment Properties partially offset by an increase of \$0.1 million in the Office Development Properties. Other property income from Office Properties decreased approximately \$22.8 million to \$0.4 million for the nine months ended September 30, 2004 compared to \$23.2 million for the nine months ended September 30, 2003. Other Property Income for the nine months ended September 30, 2003 included an \$18.0 million lease termination fee related to a settlement with Peregrine Systems Inc. In accordance with the settlement agreement approved by the bankruptcy court, the Company received a payment of \$18.3 million from Peregrine in 2003 and was scheduled to receive four additional payments of approximately \$750,000 each to be paid annually over the next four years. The future payments were recorded at their net present value which was approximately \$2.6 million. The lease termination fee of \$18.0 represents the \$18.3 million payment plus the \$2.6 million net present value of the future payments, offset by \$2.9 million in receivables and other costs and obligations associated with the leases. The future payments were reserved for financial reporting purposes at September 30, 2003 through the provision for bad debts. Other property income for the nine months ended September 30, 2003 also included a \$4.3 million lease termination fee resulting from the early termination of leases at a building in San Diego, California. Other property income for the nine months ended September 30, 2004 included \$1.3 million of other income related to a lease termination in 2001 and \$0.9 million of lease termination fees. The \$1.3 million had previously been reserved for financial reporting purposes until certain contingencies associated with the lease termination had been resolved. This income was partially offset by a \$1.8 million charge related to a proposed settlement for outstanding litigation.

Total expenses from Office Properties increased \$2.3 million, or 6.9%, to \$35.0 million for the nine months ended September 30, 2004 compared to \$32.7 million for the nine months ended September 30, 2003. Property expenses from Office Properties increased \$2.4 million, or 11.0%, to \$23.8 million for the nine months ended September 30, 2004 compared to \$21.4 million for the nine months ended September 30, 2003. An increase of \$1.3 million, or 6.4%, was generated by the Core Office Portfolio. This increase was primarily attributable to an increase in property management expenses, janitorial and other contract services due to an increase in occupancy. The remaining \$1.1 million increase in property expenses is attributable to an increase of \$1.3 million in the Office Development Properties partially offset by a decrease of \$0.2 million in the Office Redevelopment Properties. The increase in the Office Development Properties is primarily due to an increase in variable operating expenses related to an increase in occupancy. Real estate taxes increased \$1.2 million, or 13.1%, to \$10.2 million for the nine months ended September 30, 2004 as compared to \$9.0 million for the same period in 2003. Real estate taxes for the Core Office Portfolio increased \$0.3 million, or 4.0%, to \$8.6 million for the nine months ended September 30, 2004 compared to \$8.3 for the comparable period in 2003. This increase was mainly attributable to refunds received during the nine months ended September 30, 2003 for real estate taxes that were successfully appealed by the Company. The remaining increase of \$0.9 million was attributable to a \$0.7 million increase in the Office Development Properties and a \$0.2 million increase in the Office Redevelopment Properties. The provision for bad debts decreased \$1.3 million, or 95.3%, for the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003. This decrease was primarily due to the decrease in the provision the Company recorded for its leases with Peregrine. During the nine months ended September 30, 2003 the Company recorded a \$2.6 million provision to reserve for future payments due under the Peregrine settlement agreement, and reduced a previously recorded provision for unbilled deferred rents related to the Company's leases with Peregrine by \$2.0 million as a result of the settlement with Peregrine in July 2003 as discussed in the preceding paragraph. During the nine months ended September 30, 2004 the Company reversed \$0.8 million of the provision for the future installment payments due to the collection of the first of four annual installment payments due under the settlement agreement. The Company evaluates its reserve levels on a quarterly basis. Ground lease expense for Office Properties remained consistent at \$1.0 million for the nine months ended September 30, 2004 compared to the same period in 2003.

Net operating income, as defined, from Office Properties decreased \$8.9 million, or 8.3%, to \$98.7 million for the nine months ended September 30, 2004 compared to \$107.6 million for the nine months ended

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September 30, 2003. Of this decrease, \$9.3 million was attributable to the Core Office Portfolio and \$6.2 million was attributable to the Office Redevelopment Properties, which was partially offset by an increase of \$6.6 million attributable to the Office Development Properties.

Industrial Properties

| | Total Industrial Portfolio(1) | | | |
|---|--------------------------------------|------------------|--------------------------|------------------------------|
| | 2004 | 2003 | Dollar Change | Percentage Change |
| (in thousands) | | | | |
| Operating revenues: | | | | |
| Rental income | \$ 23,561 | \$ 24,237 | \$ (676) | (2.8)% |
| Tenant reimbursements | 2,629 | 2,618 | 11 | 0.4 |
| Other property income | 13 | 143 | (130) | (90.9) |
| Total | 26,203 | 26,998 | (795) | (2.9) |
| Property and related expenses: | | | | |
| Property expenses | 1,382 | 1,111 | 271 | 24.4 |
| Real estate taxes | 2,099 | 1,943 | 156 | 8.0 |
| Provision for bad debts | 24 | 252 | (228) | (90.5) |
| Total | 3,505 | 3,306 | 199 | 6.0 |
| Net operating income, as defined | \$ 22,698 | \$ 23,692 | \$ (994) | (4.2)% |

(1) The Total Industrial Portfolio is equivalent to the Company's Core Industrial Portfolio at September 30, 2004, which represents properties owned and stabilized at January 1, 2003 and still owned and stabilized at June 30, 2005, excluding the building classified as held for sale as of June 30, 2005.

Total revenues from Industrial Properties decreased \$0.8 million, or 2.9%, to \$26.2 million for the nine months ended September 30, 2004 compared to \$27.0 million for the nine months ended September 30, 2003. Rental income from Industrial Properties decreased \$0.7 million, or 2.8%, to \$23.5 million for the nine months ended September 30, 2004 compared to the \$24.2 million for the nine months ended September 30, 2003. This decrease was primarily due to a decline in occupancy in the Industrial Portfolio. Average occupancy in the Industrial Portfolio decreased 2.4% to 94.4% for the nine months ended September 30, 2004 compared to 96.8% for the nine months ended September 30, 2003.

Tenant reimbursements from Industrial Properties remained consistent at approximately \$2.6 million during the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003. Other property income from Industrial Properties decreased \$0.1 million for the nine months ended September 30, 2004 as compared to the nine months ended September 30, 2003. Other property income for both periods consisted primarily of lease termination fees and other related income associated with early lease terminations.

Total expenses from Industrial Properties increased \$0.2 million, or 6.0%, to \$3.5 million for the nine months ended September 30, 2004 compared to \$3.3 million for the nine months ended September 30, 2003. Property expenses from Industrial Properties increased by \$0.3 million, or 24.4%, to \$1.4 million for the nine months ended September 30, 2004 compared to \$1.1 million for the nine months ended September 30, 2003. This increase was primarily attributable to non-recurring HVAC expenses. Real estate taxes for the Industrial Properties

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increased \$0.2 million, or 8.0%, for the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003. This increase was primarily due to refunds received during the nine months ended September 30, 2003 for real estate taxes that were successfully appealed by the Company. The provision for bad debts decreased \$0.2 million, or 90.5%, for the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003. During the nine months ended September 30, 2004 the Company's reserve requirement decreased due to the collection of previously reserved receivables. The Company evaluates its reserve levels on a quarterly basis.

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Net operating income, as defined, from Industrial Properties decreased \$1.0 million, or 4.2%, to \$22.7 million for the nine months ended September 30, 2004 compared to \$23.7 million for the nine months ended September 30, 2003.

Non-Property Related Income and Expenses

Interest and other income increased approximately \$0.3 million, or 255.4%, to \$0.4 million for the nine months ended September 30, 2004 compared to \$0.1 million for the nine months ended September 30, 2003. This increase was primarily due to a \$0.1 million net realized gain from the sale of stock that the Company received in satisfaction of a creditor's claim under a lease that was terminated early. (See Note 8 to the Company's consolidated financial statements.). Additionally, during the nine months ended September 30, 2004, the Company recorded \$0.1 million in non-recurring interest earned in connection with a reimbursement of prior year supplemental property taxes.

General and administrative expenses increased \$9.1 million, or 68.9%, to \$22.3 million for the nine months ended September 30, 2004 compared to \$13.2 million for the nine months ended September 30, 2003. The increase is primarily due to a \$8.2 million increase in accrued incentive compensation and was driven by a special long-term incentive plan for the Company's executives for which the amount payable under the plan is based on the Company's absolute and relative shareholder returns (see Note 7 to the Company's consolidated financial statements for further discussion about the program). The plan is accounted for using variable plan accounting, which requires the Company to record the cumulative charge to the income statement based on the quoted closing price per share for the Company's common stock for the period. The closing price per share for the Company's common stock as of September 30, 2004 was \$38.03 as compared to \$28.55 as of September 30, 2003. The amounts recorded in future periods related to this plan will increase and decrease as the Company's closing quarterly share price increases and decreases. The remaining increase was primarily due to the reversal of a \$0.5 million reserve in the second quarter of 2003 in connection with the Peregrine settlement agreement. The Company had initially recorded this reserve in the second quarter of 2002 for costs the Company paid for the fifth and final building that was to be leased to Peregrine. The building was surrendered to the Company in June 2002.

Net interest expense increased \$3.8 million, or 15.6%, to \$27.9 million for the nine months ended September 30, 2004 compared to \$24.1 million for the nine months ended September 30, 2003. Gross interest and loan fee expense, before the effect of capitalized interest and loan fees increased \$0.4 million, or 1.1%, to \$34.3 million for the nine months ended September 30, 2004 compared to \$33.9 million for the nine months ended September 30, 2003. Total capitalized interest and loan fees decreased \$3.4 million, or 34.7%, to \$6.4 million for the nine months ended September 30, 2004 from \$9.8 million for the nine months ended September 30, 2003 due to lower construction in progress balances eligible for capitalization during the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003.

Depreciation and amortization increased \$2.2 million, or 5.5%, to \$42.2 million for the nine months ended September 30, 2004 compared to \$40.0 million for the nine months ended September 30, 2003. An increase of \$3.0 million was attributable to the Office Development Properties partially offset by a decrease of \$0.8 million related to the Office Redevelopment Properties taken out of service in 2003.

Table of Contents**Building and Lease Information**

The following tables set forth certain information regarding the Company's Office Properties and Industrial Properties at September 30, 2004:

Occupancy by Segment Type

| | Number of Buildings | Total Square Feet | Occupancy |
|-------------------------------|--------------------------------|------------------------------|------------------|
| Office Properties: | | | |
| Los Angeles | 26 | 2,872,925 | 89.4% |
| Orange County | 7 | 387,327 | 97.5 |
| San Diego | 41 | 3,253,382 | 96.4 |
| Other | 8 | 878,960 | 91.5 |
| Total Office | 82 | 7,392,594 | 93.2 |
| Industrial Properties: | | | |
| Los Angeles | 4 | 388,805 | 51.0 |
| Orange County | 43 | 3,917,345 | 96.6 |
| Other | 2 | 295,417 | 100.0 |
| Total Industrial | 49 | 4,601,567 | 92.9 |
| Total Portfolio | 131 | 11,994,161 | 93.1% |

Lease Expirations by Segment Type

| Year of Lease Expiration | Number of Expiring Leases(1) | Total Square Footage of Expiring Leases | Percentage of Total Leased Square Feet Represented by Expiring Leases(2) | Annual Base Rent Under Expiring Leases (in 000 \$)(3) |
|---------------------------------|---|--|---|---|
| Office Properties: | | | | |
| Remaining 2004(4) | 11 | 77,595 | 1.1% | \$ 1,522 |
| 2005 | 60 | 629,323 | 9.2 | 13,723 |
| 2006 | 57 | 698,066 | 10.2 | 16,621 |
| 2007 | 65 | 1,156,914 | 17.0 | 22,487 |
| 2008 | 45 | 1,024,424 | 15.0 | 24,285 |
| 2009 | 47 | 1,062,156 | 15.6 | 27,062 |
| Total Office | 285 | 4,648,478 | 68.1 | 105,700 |

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| Industrial Properties: | | | | |
|-------------------------------|------------|------------------|--------------|-------------------|
| Remaining 2004(4) | 1 | 20,133 | 0.5 | 138 |
| 2005 | 16 | 770,060 | 18.0 | 6,035 |
| 2006 | 12 | 494,461 | 11.6 | 4,359 |
| 2007 | 14 | 668,776 | 15.6 | 5,088 |
| 2008 | 9 | 860,407 | 20.1 | 6,838 |
| 2009 | 11 | 678,661 | 15.9 | 4,955 |
| Total Industrial | 63 | 3,492,498 | 81.7 | 27,413 |
| Total | 348 | 8,140,976 | 73.4% | \$ 133,113 |

- (1) Represents the total number of tenants. Some tenants have multiple leases. Excludes leases for amenity, retail, parking and month-to-month tenants.
(2) Based on total leased square footage for the respective portfolios as of September 30, 2004.
(3) Determined based on monthly GAAP rent at September 30, 2004, multiplied by 12, including all leases executed on or before September 30, 2004.
(4) Represents leases expiring in 2004 that have not been renewed as of September 30, 2004.

Table of Contents**Leasing Activity by Segment Type**

| | Number of Leases(1) | | Rentable Square Feet(1) | | Change in Rents(2) | Change in Cash Rents(3) | Retention Rates(4) | Weighted Average Lease Term (in months) |
|---|---------------------|-----------|-------------------------|----------------|--------------------|-------------------------|--------------------|---|
| | New | Renewal | New | Renewal | | | | |
| | | | | | | | | |
| For the Three Months Ended September 30, 2004: | | | | | | | | |
| Office Properties | 22 | 8 | 281,677 | 347,074 | (13.3)% | (22.2)% | 97.2% | 63 |
| Industrial Properties | 1 | 2 | 6,000 | 52,888 | (4.1)% | (7.0)% | 39.0% | 19 |
| Total | 23 | 10 | 287,677 | 399,962 | (13.0)% | (21.7)% | 81.2% | 59 |

| | Number of Leases(1) | | Rentable Square Feet(1) | | Change in Rents(2) | Change in Cash Rents(3) | Retention Rates(4) | Weighted Average Lease Term (in months) |
|--|---------------------|-----------|-------------------------|----------------|--------------------|-------------------------|--------------------|---|
| | New | Renewal | New | Renewal | | | | |
| | | | | | | | | |
| For the Nine Months Ended September 30, 2004: | | | | | | | | |
| Office Properties | 51 | 22 | 511,815 | 442,023 | (7.8)% | (15.1)% | 89.7% | 66 |
| Industrial Properties | 4 | 11 | 55,854 | 356,083 | 3.3% | (6.6)% | 76.7% | 39 |
| Total | 55 | 33 | 567,669 | 798,106 | (6.1)% | (13.7)% | 83.3% | 58 |

(1) Represents leasing activity for leases commencing during the period shown, including first and second generation space net of month-to-month leases. Excludes leasing on new construction.

(2) Calculated as the change between GAAP rents for new/renewed leases and the expiring GAAP rents for the same space. Excludes leases for which the space was vacant for longer than one year.

(3) Calculated as the change between stated rents for new/renewed leases and the expiring stated rents for the same space. Excludes leases for which the space was vacant for longer than one year. The change in cash rents for two of the leases that commenced during the nine months ended September 30, 2004 was calculated using the leases' stabilized stated rent. The starting stated rents for these two leases were discounted for the first six months.

(4) Calculated as the percentage of space either renewed or newly leased by existing tenants at lease expiration.

Table of Contents**Development and Redevelopment**

The following tables set forth certain information regarding the Company's in-process and committed office development and redevelopment projects as of September 30, 2004. See further discussion regarding the Company's projected development and redevelopment trends under the caption "Factors That May Influence Future Results of Operations" Development and redevelopment programs.

Development Projects

| Project Name/Submarket | Estimated Completion Date | Estimated Stabilization Date(1) | Projected | | Total | Percent |
|--|---------------------------|---------------------------------|-----------------------------|-------------------------------|--------------------------------|---------------------------------|
| | | | Square Feet Upon Completion | Total Estimated Investment(2) | Costs as of September 30, 2004 | Leased as of September 30, 2004 |
| (in thousands) | | | | | | |
| Projects Under Construction: | | | | | | |
| 15227 Avenue of Science Rancho Bernardo, CA | 3 rd Qtr 2005 | 3 rd Qtr 2006 | 65,867 | \$ 13,873 | \$ 5,423 | |
| 15253 Avenue of Science Rancho Bernardo, CA | 3 rd Qtr 2005 | 3 rd Qtr 2006 | 37,405 | 8,926 | 4,239 | |
| Total In-Process Projects: | | | 103,272 | \$ 22,799 | \$ 9,662 | |

(1) Based on management's estimation of the earlier of stabilized occupancy (95.0%) or one year from the date of substantial completion.

(2) Represents total projected development costs at September 30, 2004.

Redevelopment Projects

| Project Name/ Submarket | Pre- and Post-Redevelopment Type | Completion Date | Estimated Stabilization Date(1) | Square Feet Upon Completion | Existing Investment(2) | Estimated Redevelopment Costs(3) | Total Estimated Investment | Total Costs | Percent Leased |
|--|----------------------------------|--------------------------|---------------------------------|-----------------------------|------------------------|----------------------------------|----------------------------|--------------------------|--------------------------|
| | | | | | | | | as of September 30, 2004 | as of September 30, 2004 |
| (in thousands) | | | | | | | | | |
| Projects in Lease-Up: | | | | | | | | | |
| 5717 Pacific Center Blvd. Sorrento Mesa, CA | Office to Life Science | 1 st Qtr 2004 | 1 st Qtr 2005 | 67,995 | \$ 8,790 | \$ 10,320 | \$ 19,110 | \$ 10,817 | |
| 909 Sepulveda Blvd. El Segundo, CA | Office | 3 rd Qtr 2004 | 3 rd Qtr 2005 | 241,603 | 37,799 | 27,509 | 65,308 | 50,738 | 19% |
| Total In-Process Projects | | | | 309,598 | \$ 46,589 | \$ 37,829 | \$ 84,418 | \$ 61,555 | 15% |

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- (1) Based on management's estimation of the earlier of stabilized occupancy (95.0%) or one year from the date of substantial completion.
- (2) Represents total capitalized costs at the commencement of redevelopment.
- (3) Represents total projected redevelopment cost at September 30, 2004.

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Liquidity and Capital Resources

Current Sources of Capital and Liquidity

The Company seeks to create and maintain a capital structure that allows for financial flexibility and diversification of capital resources. The Company's primary source of liquidity to fund distributions, debt service, leasing costs and capital expenditures is net cash from operations. The Company's primary sources of liquidity to fund development and redevelopment costs, potential undeveloped land and property acquisitions, temporary working capital and unanticipated cash needs are the Company's \$425 million unsecured revolving line of credit, proceeds received from the Company's disposition program and construction loans. As of September 30, 2004, the Company's total debt as a percentage of total market capitalization (presented on page 37) was 34.4%. As of September 30, 2004, the Company's total debt plus preferred equity as a percentage of total market capitalization was 41.9%.

As of September 30, 2004, the Company had borrowings of \$92.0 million outstanding under its revolving unsecured line of credit (the Credit Facility) and availability of approximately \$251.4 million. The Credit Facility bore interest at an annual rate of LIBOR plus 1.50% for the nine months ended September 30, 2004 (3.26% at September 30, 2004).

On October 22, 2004, the Company obtained a new \$425 million unsecured revolving credit facility (New Credit Facility) to replace the Credit Facility that was scheduled to mature in March 2005. The New 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, 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 New Credit Facility to finance development and redevelopment expenditures, to fund potential acquisitions and for other general corporate uses.

Factors That May Influence Future Sources of Capital and Liquidity

In 2003 and 2002, the Company used proceeds from dispositions of operating properties of approximately \$34.1 million and \$46.5 million, respectively, to fund a portion of its development and redevelopment activities and its share repurchase program. The Company disposed of one office property and one industrial property for net cash proceeds aggregating approximately \$34.8 million during the nine months ended September 30, 2004. Management currently does not expect to dispose of any additional properties during the remainder of 2004 and continues to evaluate other financing sources to fund its development and redevelopment activities.

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The following table sets forth certain information with respect to the Company's aggregate debt composition at September 30, 2004 and December 31, 2003:

| | Percentage of Total Debt | | Weighted-Average Interest Rate | |
|---------------------------------------|--------------------------|-------------------|--------------------------------|-------------------|
| | September 30, 2004 | December 31, 2003 | September 30, 2004 | December 31, 2003 |
| Secured vs. unsecured: | | | | |
| Secured | 67.7% | 69.1% | 6.0% | 5.8% |
| Unsecured | 32.3% | 30.9% | 5.4% | 4.2% |
| Fixed-rate vs. variable-rate: | | | | |
| Fixed-rate(1)(2)(3)(4) | 99.7% | 72.6% | 5.8% | 6.3% |
| Variable-rate | 0.3% | 27.4% | 3.2% | 2.8% |
| Total Debt | | | 5.8% | 5.3% |
| Total Debt Including Loan Fees | | | 6.5% | 5.9% |

- (1) At September 30, 2004, the Company had an interest-rate swap agreement, which expires in January 2005, to fix LIBOR on \$50 million of its variable-rate debt at 4.46%.
- (2) At September 30, 2004, the Company had an interest-rate swap agreement, which expires in November 2005, to fix LIBOR on \$50 million of its variable-rate debt at 2.57%.
- (3) At September 30, 2004, the Company had two interest-rate swap agreements, which expire in December 2006, to fix LIBOR on \$50 million of its variable-rate debt at 2.98%.

Following is the Company's total market capitalization as of September 30, 2004:

| | Shares/Units at September 30, 2004 | Aggregate Principal Amount or \$ Value Equivalent | % of Total Market Capitalization |
|--|------------------------------------|---|----------------------------------|
| Debt: | | | |
| Secured debt | | \$ 494,932 | 23.3% |
| Unsecured senior notes | | 144,000 | 6.8 |
| Unsecured line of credit | | 92,000 | 4.3 |
| Total debt | | 730,932 | 34.4 |
| Equity: | | | |
| 7.450% Series A Cumulative Redeemable Preferred Units(1) | 1,500,000 | 75,000 | 3.5 |
| 9.250% Series D Cumulative Redeemable Preferred Units(1) | 900,000 | 45,000 | 2.1 |
| 7.800% Series E Cumulative Redeemable Preferred Stock(2) | 1,610,000 | 40,250 | 1.9 |
| Common units outstanding(3) | 3,990,485 | 151,758 | 7.1 |
| Common shares outstanding(3) | 28,527,920 | 1,084,917 | 51.0 |
| Total equity | | 1,396,925 | 65.6 |
| Total Market Capitalization | | \$ 2,127,857 | 100.0% |

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- (1) Value based on \$50.00 per share liquidation preference.
 - (2) Value based on \$25.00 per share liquidation preference.
 - (3) Value based on closing share price of \$38.03 at September 30, 2004.

Table of Contents**Contractual Obligations**

The following table provides information with respect to the maturities and scheduled principal repayments of the Company's secured debt and New Credit Facility and scheduled interest payments of the Company's fixed-rate debt and interest-rate swap agreements at September 30, 2004 and provides information about the minimum commitments due in connection with the Company's ground lease obligations and capital commitments at September 30, 2004. The table does not reflect available maturity extension options.

| | Payment Due by Period | | | | Total |
|---|------------------------------|---------------------------|---------------------------|--------------------------------------|---------------------|
| | (in thousands) | | | | |
| | Fourth Quarter of 2004 | Fiscal Years 2005-2006 | Fiscal Years 2007-2008 | Fiscal Years Ending After 2008 | |
| Principal payments secured debt | \$ 2,454 | \$ 90,420 | \$ 114,970 | \$ 287,088 | \$ 494,932 |
| Principal payments New Credit Facility(1) | | | 92,000 | | 92,000 |
| Principal payments unsecured senior notes | | | | 144,000 | 144,000 |
| Interest payments fixed-rate debt(2) | 6,539 | 68,015 | 61,856 | 86,190 | 222,600 |
| Interest payments interest-rate swaps(2)(3) | 1,279 | 2,987 | | | 4,266 |
| Ground lease obligations(4) | 401 | 3,214 | 3,151 | 69,796 | 76,562 |
| Capital commitments(5) | 12,124 | | | | 12,124 |
| Total | \$ 22,797 | \$ 164,636 | \$ 271,977 | \$ 587,074 | \$ 1,046,484 |

- (1) On October 22, 2004, the Company renewed its \$425 million unsecured revolving credit facility that was scheduled to mature in March 2005. This table reflects the new maturity date of October 22, 2007. The Company has a one-year extension option.
- (2) As of September 30, 2004, 99.7% of the Company's debt was contractually fixed or constructively fixed through interest-rate swap agreements. The information in the table above reflects the Company's projected interest rate obligations for these fixed-rate payments based on the contractual interest rates, interest payment dates and scheduled maturity dates. The remaining 0.3% of the Company's debt bears interest at variable rates and the variable interest rate payments are based on LIBOR plus a spread that ranges from 1.40% to 1.75%. The interest payments on the Company's variable-rate debt have not been reported in the table above because management cannot reasonably determine the future interest obligations on its variable-rate debt as management cannot predict what LIBOR rates will be in the future. As of September 30, 2004, one-month LIBOR was 1.84%.
- (3) Represents the scheduled interest payments for the Company's total outstanding interest-rate swap agreements as of September 30, 2004, based on the contractual interest rates, interest payment dates and maturity dates. The interest payments are reported at the gross amount and do not reflect the offsetting variable payment to be received from the counterparty. The Company employs derivative instruments for hedging purposes only and does not hold interest-rate swaps for speculative purposes. These cash flow hedges effectively convert a portion of the Company's variable-rate debt to fixed-rate debt. The Company had interest-rate swap agreements with a total notional amount of \$150 million as of September 30, 2004.
- (4) The Company has noncancelable ground lease obligations for the SeaTac Office Center in Seattle, Washington expiring in December 2032, with an option to extend the lease for an additional 30 years; and Kilroy Airport Center in Long Beach, California with a lease period for Phases I, II, III and IV expiring in July 2084.
- (5) Amounts represent commitments under signed leases and contracts. See further discussion under the caption "Capital Commitments" below.

The New Credit Facility, unsecured senior notes, and certain other secured debt agreements contain covenants and restrictions requiring the Company to meet certain financial ratios and reporting requirements. Some of the more restrictive covenants include a maximum total debt to total assets ratio, a maximum total secured debt to total assets ratio, minimum debt service coverage and fixed charge coverage ratios, a minimum consolidated tangible net worth and a limit of development activities as compared to total assets. Non-compliance with one or more of the covenants and restrictions could result in the full or partial principal balance of the associated debt becoming immediately due and payable. The Company was in compliance with all its covenants at September 30, 2004.

Capital Commitments

As of September 30, 2004, the Company had two development projects under construction and two redevelopment projects that were in the lease-up phase. These projects have a total estimated investment of approximately \$107 million. The Company has incurred an aggregate of approximately \$71 million on these

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projects as of September 30, 2004, and currently projects it could spend approximately \$8 million of the remaining \$36 million of presently budgeted development costs during the remainder of 2004, depending on leasing activity. In addition, the Company had three development projects that were added to the Company's stabilized portfolio of operating properties in 2003 and 2004, which had not yet reached stabilized occupancy as of September 30, 2004. Depending on leasing activity, the Company currently projects it could spend approximately \$4 million for these projects during the remainder of 2004. See additional information regarding the Company's in-process development and redevelopment portfolio under the caption "Development and Redevelopment".

As of September 30, 2004, the Company had executed leases that committed the Company to \$11 million in unpaid leasing costs and tenant improvements and the Company had contracts outstanding for approximately \$1 million in capital improvements at September 30, 2004. In addition, during the remainder of 2004, the Company plans to spend approximately \$2 million to \$6 million in capital improvements, tenant improvements, and leasing costs for properties within the Company's stabilized portfolio, depending on leasing activity. Capital expenditures may fluctuate in any given period subject to the nature, extent and timing of improvements required to maintain the Company's properties. Tenant improvements and leasing costs may also fluctuate in any given period depending upon factors such as the type of property, the term of the lease, the type of lease, the involvement of external leasing agents and overall market conditions.

Other Liquidity Needs

The Company is required to distribute 90% of its REIT taxable income (excluding capital gains) on an annual basis in order to qualify as a REIT for federal income tax purposes. Accordingly, the Company intends to continue to make, but has not contractually bound itself to make, regular quarterly distributions to common stockholders and common unitholders from cash flow from operating activities. All distributions are at the discretion of the Board of Directors. The Company may be required to use borrowings under the New Credit Facility, if necessary, to meet REIT distribution requirements and maintain its REIT status. The Company has historically distributed amounts in excess of its taxable income resulting in a return of capital to its stockholders, and currently has the ability to not increase its distributions to meet its REIT requirements for 2004. The Company considers market factors and Company performance in addition to REIT requirements in determining its distribution levels. Amounts accumulated for distribution to shareholders are invested primarily in interest-bearing accounts and short-term interest-bearing securities, which are consistent with the Company's intention to maintain its qualification as a REIT. Such investments may include, for example, obligations of the Government National Mortgage Association, other governmental agency securities, certificates of deposit and interest-bearing bank deposits. On September 17, 2004, the Company declared a regular quarterly cash dividend of \$0.495 per common share, which was paid on October 15, 2004 to stockholders of record on September 30, 2004. This dividend is equivalent to an annual rate of \$1.98 per share. In addition the Company is required to make quarterly distributions to its Series A and Series D Preferred unitholders and Series E Preferred Stockholders, which in aggregate total approximately \$13 million of annualized preferred dividends and distributions.

The Company's Board of Directors has approved a share repurchase program, pursuant to which the Company is authorized to repurchase up to an aggregate of four million shares of its outstanding common stock. An aggregate of 1,227,500 shares currently remain eligible for repurchase under this program. The Company may opt to repurchase shares of its common stock in the future depending upon market conditions. The Company did not repurchase shares of common stock under this program during the nine months ended September 30, 2004.

The Company believes that it will have sufficient capital resources to satisfy its liquidity needs over the next twelve-month period. The Company expects to meet its short-term liquidity needs, which may include principal repayments of its debt obligations, capital expenditures and distributions to common and preferred stockholders and unitholders, through retained cash flow from operations and borrowings under the New Credit Facility.

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The Company expects to meet its long-term liquidity requirements, which may include property and undeveloped land acquisitions and additional future development and redevelopment activity, through retained cash flow, borrowings under the New Credit Facility, additional long-term secured and unsecured borrowings, dispositions of non-strategic assets, issuance of common or preferred units of the Operating Partnership, and the potential issuance of debt or equity securities of the Company. The Company does not intend to reserve funds to retire existing debt upon maturity. The Company presently expects to refinance such debt at maturity or retire such debt through the issuance of equity securities, as market conditions permit.

Off Balance Sheet Arrangements

As of September 30, 2004, the Company did not have any off-balance sheet transactions, arrangements or obligations, including contingent liabilities.

Historical Cash Flows

The principal sources of funding for development, redevelopment, acquisitions and capital expenditures are cash flows from operating activities, the Credit Facility, secured and unsecured debt financing and proceeds from the Company's dispositions. The Company's net cash provided by operating activities decreased \$13.3 million, or 13.7%, to \$84.4 million for the nine months ended September 30, 2004 compared to the \$97.7 million for the nine months ended September 30, 2003. The decrease is primarily attributable to a lease termination fee payment of \$18.3 million received in connection with the Peregrine settlement agreement in the third quarter of 2003. This decrease is offset by an increase in average occupancy in the Core Office Portfolio. For the nine months ended September 30, 2004, average occupancy in this portfolio was 93.0% as compared to 89.3% for the nine months ended September 30, 2003.

Net cash used in investing activities decreased \$36.4 million, or 95.9%, to \$1.6 million for the nine months ended September 30, 2004 compared to \$38.0 million for the nine months ended September 30, 2003. The decrease was primarily attributable to a decrease in development spending. The Company scaled back its development activity during the last two years as a result of the economic environment and the related impact on leasing. In July 2004, the Company commenced construction on the third phase of a development project that will include two office buildings. As a result, development spending is likely to increase over the next year. See additional information regarding the Company's development programs and anticipated development spending under the captions "Development and redevelopment programs" and "Capital Commitments".

Net cash used in financing activities increased \$29.7 million, or 50.0%, to \$89.1 million for the nine months ended September 30, 2004 compared to \$59.4 million for the nine months ended September 30, 2003. This increase was primarily attributable to a \$19.9 million decrease in net borrowing activity for the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003, which was mainly due to the Company scaling back its development activity as discussed in the paragraph above.

Non-GAAP Supplemental Financial Measure: Funds From Operations

Management believes that Funds From Operations (FFO) is a useful supplemental measure of the Company's operating performance. The Company computes FFO in accordance with the White Paper on FFO approved by the Board of Governors of the National Association of Real Estate Investment Trusts (NAREIT). The White Paper defines FFO as net income or loss computed in accordance with generally accepted accounting principles (GAAP), excluding extraordinary items, as defined by GAAP, and gains and losses from sales of depreciable operating

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property, plus real estate related depreciation and amortization (excluding amortization of deferred financing costs and depreciation of non-real estate assets), and after adjustment for unconsolidated partnerships and joint ventures. Other REITs may use different methodologies for calculating FFO, and accordingly, the Company's FFO may not be comparable to other REITs.

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Because FFO excludes depreciation and amortization, gains and losses from property dispositions and extraordinary items, it provides a performance measure that, when compared year over year, reflects the impact to operations from trends in occupancy rates, rental rates, operating costs, development activities, general and administrative expenses and interest costs, providing perspective on operating performance not immediately apparent from net income. In addition, management believes that FFO provides useful information to the investment community about the Company's operating performance when compared to other REITs since FFO is generally recognized as the industry standard for reporting the operations of REITs.

However, FFO should not be viewed as an alternative measure of the Company's operating performance since it does not reflect either depreciation and amortization costs or the level of capital expenditures and leasing costs necessary to maintain the operating performance of the Company's properties, which are significant economic costs and could materially impact the Company's results from operations.

The following table reconciles the Company's FFO to the Company's GAAP net income for the three and nine months ended September 30, 2004 and 2003.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|------------------|------------------------------------|------------------|
| | 2004 | 2003 | 2004 | 2003 |
| | (in thousands) | | | |
| Net income available for common shareholders | \$ 10,357 | \$ 20,039 | \$ 24,194 | \$ 44,325 |
| Adjustments: | | | | |
| Minority interest in earnings of Operating Partnership | 1,381 | 3,059 | 3,504 | 6,801 |
| Depreciation and amortization | 14,659 | 14,327 | 42,974 | 41,200 |
| Net (gain) loss on dispositions of operating properties | (6,212) | 48 | (6,148) | (3,642) |
| Funds From Operations(1) | \$ 20,185 | \$ 37,473 | \$ 64,524 | \$ 88,684 |

(1) Reported amounts are attributable to common shareholders and common unitholders.

Inflation

The majority of the Company's tenant leases require tenants to pay most operating expenses, including real estate taxes, utilities, insurance and increases in common area maintenance expenses, which reduces the Company's exposure to increases in costs and operating expenses resulting from inflation.

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ITEM 4. CONTROLS AND PROCEDURES

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in its reports under the Securities Exchange Act of 1934 is processed, recorded, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any system of controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Subsequent to the filing of the original Form 10-Q for the quarter ended September 30, 2004, management discovered an error in the computation of income from continuing operations per common share included within the consolidated statements of operations, and determined that the error required the restatement of per share amounts for income from continuing operations, basic and diluted, for the three and nine months ended September 30, 2004. The Company incorrectly calculated the per share results of income from continuing operations, basic and diluted, by not deducting the impact of dividends paid and accrued to its preferred stockholders. In accordance with Statement of Financial Accounting Standards No. 128, Earnings per Share, the Company should have presented income from continuing operations per share net of preferred dividends paid and accrued to its preferred stockholders. Also subsequent to filing of the original Form 10-Q for the quarter ended September 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 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 consolidated 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.

The required restatements caused management to conclude that the Company had a material weakness in its internal control over financial reporting because the controls over the initial analysis of accounting guidance did not identify the impact of significant new corporate transactions on a per share disclosure required on the consolidated statements of operations or the appropriate classification of two specific items on the consolidated statements of cash flows.

As required by SEC Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the disclosure controls and procedures as of the end of the period covered by this report, which included consideration of the restatements. Based on the foregoing, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were not effective as of the end of the period covered by this report.

In light of this conclusion, the Company performed additional technical review and analysis to ensure its consolidated financial statements are prepared in accordance with generally accepted accounting principles. Accordingly, management believes that the financial statements included in this report fairly present in all material respects our financial condition, results of operations and cash flows for the periods presented.

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Changes in Internal Control Over Financial Reporting

Management had previously concluded that the Company's disclosure controls and procedures were effective as of September 30, 2004 and reported that there was no change in the Company's internal control over financial reporting that occurred during the three months ended September 30, 2004 that materially affected, or was reasonably likely to materially affect, the internal control over financial reporting. However, in connection with the restatements of the Company's consolidated financial statements for the quarter ended September 30, 2004, as fully described in Note 14 of this Quarterly Report on Form 10-Q/A for the quarter ended September 30, 2004, management determined that the material weakness described above existed as of September 30, 2004 and has, as a result, effected changes to the Company's internal control over financial reporting subsequent to the period covered by this report, that have materially affected the Company's internal control over financial reporting. The Company has implemented procedures to more formally document and review the technical analysis of all relevant accounting literature that is performed to evaluate the accounting treatment and presentation and disclosure requirements for significant and/or non-routine transactions. This review will be performed both when a transaction is completed for the first time and when a similar repeat transaction is completed, if it is significant. Management believes these enhanced procedures provide additional internal control over financial reporting and improve the ability of management to identify any potential accounting implications prior to and during the comprehensive review of the Company's consolidated financial statements. In addition, the Company has implemented a more comprehensive review of the consolidated statements of cash flows. Management believes these changes remediated the material weakness discussed above.

Table of Contents**PART II OTHER INFORMATION****ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

| <u>Exhibit Number</u> | <u>Description</u> |
|----------------------------------|--|
| 4.1 | Note and Guarantee Agreement dated August 4, 2004 by and between Kilroy Realty, L.P. and Kilroy Realty Corporation and the purchasers whose names appear in the acceptance form at the end of the Note and Guarantee Agreement.(1) |
| 4.2 | Form of 5.72% Series A Guaranteed Senior Note due 2010.(1) |
| 4.3 | Form of 6.45% Series B Guaranteed Senior Note due 2014.(1) |
| 10.1 | Fourth Amended and Restated Revolving Credit Agreement dated October 22, 2004.(2) |
| 10.2 | Fourth Amended and Restated Guaranty of Payment dated October 22, 2004.(2) |
| 31.1* | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer |
| 31.2* | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer |
| 32.1* | Section 1350 Certification of Chief Executive Officer |
| 32.2* | Section 1350 Certification of Chief Financial Officer |

* Filed herewith

(1) Incorporated by reference from Form 8-K filed with the Securities and Exchange Commission on August 11, 2004.

(2) Incorporated by reference from Form 8-K filed with the Securities and Exchange Commission on October 27, 2004.

(b) Reports on Form 8-K

The Company filed a Current Report on Form 8-K dated July 26, 2004, under Items 9 and 12, in connection with its second quarter 2004 earnings release and attached to such report its second quarter 2004 Supplemental Financial Report.

The Company filed a Current Report on Form 8-K dated August 11, 2004, under Item 5, in connection with the issuance of unsecured senior notes aggregating \$144 million.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on August 15, 2005.

KILROY REALTY CORPORATION

By: /s/ JOHN B. KILROY, JR.

John B. Kilroy, Jr.

President and Chief Executive Officer

(Principal Executive Officer)

By: /s/ RICHARD E. MORAN JR.

Richard E. Moran Jr.

*Executive Vice President and Chief Financial Officer
(Principal Financial Officer)*

By: /s/ HEIDI R. ROTH

Heidi R. Roth

*Senior Vice President and Controller
(Principal Accounting Officer)*