KILROY REALTY CORP
Form 10-Q/A
August 18, 2005
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Amendment No. 1

FORM 10-Q/A

(Mark One)

x **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)

Maryland	**95-4598246**
(State or other jurisdiction of incorporation or organization)	**(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.

Table of Contents

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.

2

Table of Contents

KILROY REALTY CORPORATION

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

TABLE OF CONTENTS

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
ASSETS		
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
Total real estate held for investment	1,730,705	1,726,286
Accumulated depreciation and amortization	(353,025)	(321,372)
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
TOTAL ASSETS	$ 1,479,379	$ 1,512,635
LIABILITIES AND STOCKHOLDERS EQUITY		
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
Total liabilities	820,293	839,468
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

Common unitholders of the Operating Partnership	61,782	66,502
Total minority interests	179,741	184,539
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)
Total stockholders equity	479,345	488,628
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 1,479,379	$ 1,512,635

See accompanying notes to consolidated financial statements.

4

Table of Contents

KILROY REALTY CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

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

	Three Months Ended September 30,		Nine Months Ended 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)

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)

	Preferred Stock	Common Stock: Number of Shares	Common Stock: Common Stock	Common Stock: Additional Paid-in Capital	Deferred Compensation	Distributions in Excess of Earnings	Accumulated Net Other Comp. Loss	Total
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)

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.

Table of Contents

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

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

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 September 30,		Nine Months Ended 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	$ 10,357	$ 20,017	$ 24,190	$ 44,251
Net income per common share:				
Basic as reported	$ 0.37	$ 0.73	$ 0.86	$ 1.62
Basic pro forma	$ 0.37	$ 0.73	$ 0.86	$ 1.62
Diluted as reported	$ 0.36	$ 0.72	$ 0.85	$ 1.61
Diluted pro forma	$ 0.36	$ 0.72	$ 0.85	$ 1.61

2. Dispositions

Dispositions

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

Location	Type	Month of Disposition	Number of Buildings	Rentable Square Feet	Sales Price (in millions)

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
Total			2	402,057	$	34.8

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:

Project Name / Submarket	Property Type	Completion Date	Stabilization Date	Number of Buildings	Rentable Square Feet	Percentage Leased
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:

Project Name / Submarket	Pre and Post Redevelopment Property Type	Completion Date	Estimated Stabilization Date(1)	Number of Buildings	Rentable Square Feet	Percentage Leased
5717 Pacific Center Blvd.						
Sorrento Mesa, CA	Office to Life Science	Q1 2004	Q1 2005	1	68,000	0%
909 Sepulveda Blvd.						
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

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

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

Type of Instrument	Notional Amount	Index	Strike	Maturity Date	Fair Market Value
	(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)

12

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 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.

Table of Contents

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.

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.

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 September 30,		Nine Months Ended 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

Interest expense	9,540	8,869	27,898	24,143
Depreciation and amortization	14,456	14,067	42,246	40,044
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
Net income	11,142	20,039	26,549	44,325
Preferred dividends	(785)		(2,355)	
Net income available to common shareholders	$ 10,357	$ 20,039	$ 24,194	$ 44,325

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

16

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 September 30,		Nine Months Ended 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

17

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 September 30,		Nine Months Ended 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

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	$ 0.36	$ 0.72	$ 0.85	$ 1.61

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.

Table of Contents

KILROY REALTY CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. Subsequent Events

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

	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	$ 0.71	$	$ (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.

Table of Contents

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.

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

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
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.

Table of Contents

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

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

Table of Contents

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

Table of Contents

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.