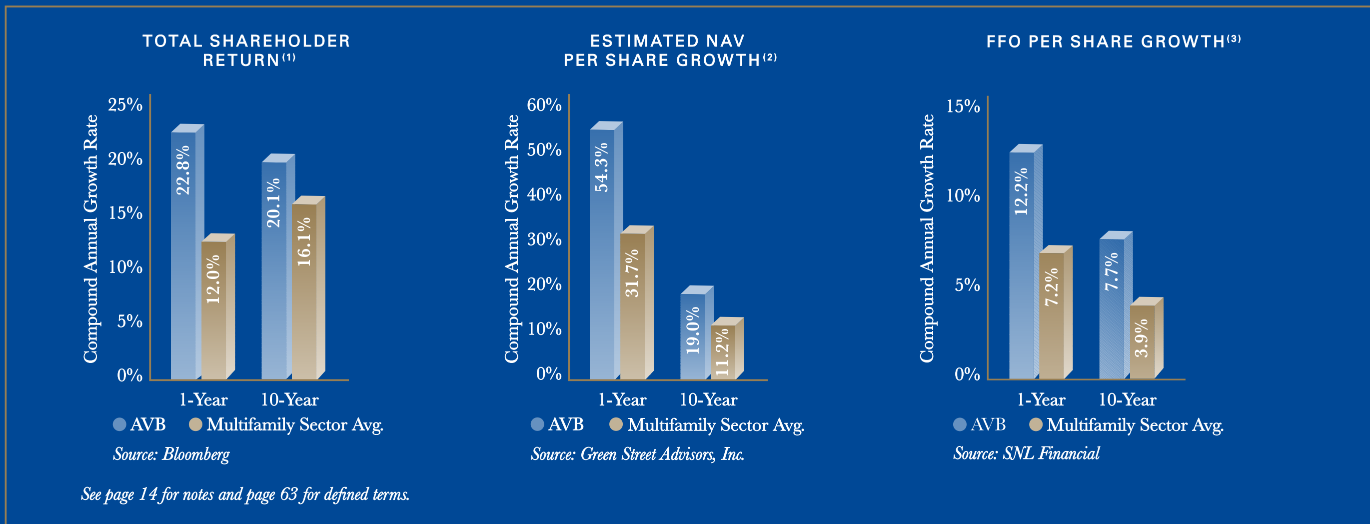
AvalonBay
COMMUNITIES, INC.

ANNUAL REPORT 2005

AvalonBay
COMMUNITIES, INC.

FINANCIAL HIGHLIGHTS



See page 14 for notes and page 63 for defined terms.

AvalonBay Communities, Inc. owns, operates, develops, redevelops and acquires quality apartment communities in high barrier-to-entry markets in the Northeast, Mid-Atlantic, Midwest, Pacific Northwest, and Northern and Southern California regions of the United States. As of December 31, 2005, we owned or held an ownership interest in 158 apartment communities containing 45,474 apartment homes in ten states and the District of Columbia, of which 17 communities were under development or redevelopment.

Our strategy is to *deeply penetrate our chosen markets with a broad range of products and services and an intense focus on our customer.* Strong execution of this strategy by our integrated operating, development, redevelopment, investment and financial teams has resulted in a history of outsized value creation and financial performance. The high barrier-to-entry nature of our markets results from constraints to new development, such as difficult and lengthy entitlement processes and limited availability of zoned and entitled land. These constraints limit new rental apartment supply. A high cost of for-sale housing in our markets also helps to support rental demand. This combination of lower new supply and a higher propensity to rent generally leads to more favorable demand/supply fundamentals in our markets over the long term.

More information about AvalonBay may be found on our website at www.avalonbay.com.

COVER PHOTO: AVALON CHRYSTIE PLACE
NEW YORK, NY
361 APARTMENT HOMES
COMPLETED NOVEMBER 2005

Positioned for Growth

AVALON AT MISSION BAY, CA

AVALON AT TRAVILLE, MD

To Our Shareholders

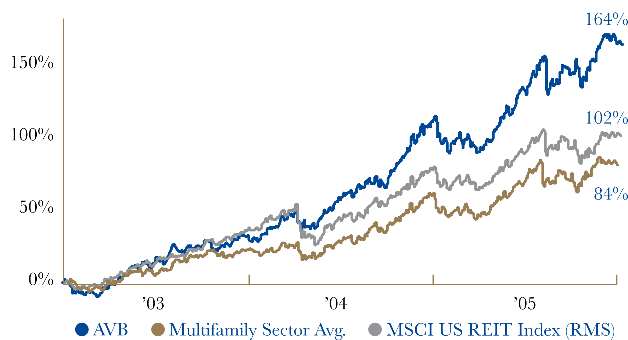
AVALON DANBURY, CT

Accelerating fundamentals, abundant capital, "condo-mania" and rising valuations were a few of the dominant trends shaping the real estate markets in 2005. Each of these trends offered opportunities for value creation, and AvalonBay participated:

- Our Same Store NOI growth accelerated throughout the year, topping 6 percent in the fourth quarter.
- As investors struggled to allocate abundant capital, our $4 billion Development Pipeline gained in importance.
- We expanded planned asset sales by 300 percent, targeting condo converters willing to pay premium prices over income buyers.
- Higher valuations were reflected in our Total Shareholder Return of 23 percent, exceeding the sector average of 12 percent.

We consider Total Shareholder Return to be an important performance measure that reflects the impact of many of these significant industry trends. Our outsized return of 23 percent was achieved while maintaining modest average Leverage of just 26 percent, well below the industry average. Simply said, relative *risk-adjusted returns* were outstanding. This is the third consecutive year we've achieved outsized returns, following 65 percent in 2004 and 30 percent in 2003.

3-YEAR TOTAL SHAREHOLDER RETURN[1]



Source: SNL Financial

AVALON PINES
LONG ISLAND, NY
298 APARTMENT HOMES
COMPLETED AUGUST 2005

Access to desirable amenities, like the 18-hole golf course at Avalon Pines, *Enhances the Lives of Our Residents.*

AVALON AT PENASQUITOS HILLS, CA

AVALON AT PRUDENTIAL CENTER, MA

We've also achieved strong growth in other key metrics such as Earnings per Share (EPS), Funds from Operations (FFO), Net Operating Income (NOI), and Net Asset Value (NAV).

Outsized risk-adjusted returns indicate excellent execution and validate our long-established strategy of *deeply penetrating our chosen markets with a broad range of products and services and an intense focus on our customer.*

In this letter, we review 2005 and discuss our future, with a focus on three significant areas:

- The economy and its impact on the industry and our performance;
- The key attributes of our strategy that create value for shareholders; and
- How we are positioned for growth and continued outperformance.

2005 IN REVIEW

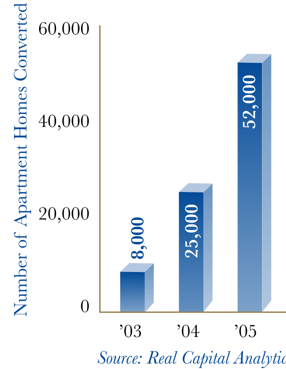
Continued economic growth finally resulted in meaningful and sustained job growth, the principal driver of rental-housing demand. Relatively low long-term interest rates generated further home price appreciation, pushing the "rent-vs.-own" economics further in our favor. Job growth and low interest rates proved to be an attractive combination to real estate investors, as capital flows to the industry continued at a brisk pace. Public-to-private M&A—another prominent trend in 2005—provided additional capital to the public markets. With Initial Year Market Capitalization Rates (Cap Rates) falling and NOI rising, we enjoyed a sharp spike in valuations—hitting the "sweet spot" of the real estate cycle. As the spread between new development yields and dispositions widened, we responded by expanding development activity and increasing dispositions, creating value on both sides of this historically wide spread.

AVALON ROCKMEADOW, WA

AVALON ESTATES, MA

Condominium sales and conversion of rental to for-sale was *"the"* story for most of the year. We sold into this strong market, selling seven assets totaling $350 million at a weighted average Cap Rate of 3.8 percent and an Unleveraged IRR of 18 percent over their eight-year weighted average holding period. Economic Gains totaled $185 million. With a substantial portion of these sales made to condo converters, we enjoyed the added benefit of removing units from the rental market and improving the performance of our remaining assets. The level of condo conversion activity may impact the liquidity for asset sales, but we are not unduly reliant on condo converters as a source of capital or sales.

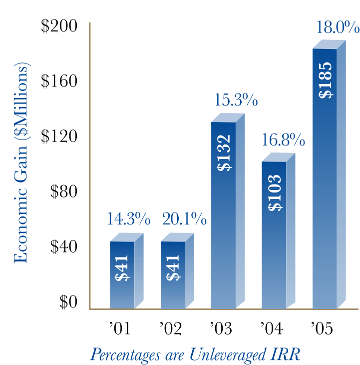
CONDOMINIUM CONVERSIONS IN AVALONBAY MARKETS



Source: Real Capital Analytics

Gains on asset sales and rising operating income drove EPS to a record level of $4.21, an increase of 44 percent over 2004. FFO was $3.77 per share, increasing 12 percent over 2004 and exceeding our original outlook. The principal reasons for this outperformance were better than expected revenue and operating results, opportunistic land sales and a sustained low interest rate environment. Continued job growth, modest new supply and a reduction in existing apartment inventory from conversion activity further supported revenue growth. These improving fundamentals and focused execution allowed us to achieve Same Store revenue growth of 3.6 percent and, through constrained expenses, NOI growth of 4.2 percent.

ASSET SALES– HARVESTING VALUE



Percentages are Unleveraged IRR

Anticipating these improving fundamentals, we increased development starts in 2005 to $880 million from $240 million in 2004, timing new apartment deliveries for what we expect to be a robust leasing environment in 2006 and 2007.

AVALON JUANITA VILLAGE
KIRKLAND, WA
211 APARTMENT HOMES
COMPLETED OCTOBER 2005

A convenient in-fill location, such as that provided by Avalon Juanita Village, often represents the key attraction for our young professional residents.

AVALON AT CRANE BROOK, MA

AVALON TOWERS BY THE BAY, CA

LOOKING FORWARD—POSITIONED FOR GROWTH

With the backdrop of an expanding economy, continued job formation and revenue growth that accelerated into 2006, we are optimistic about the next several years and are well positioned for growth and outsized relative risk-adjusted returns. We believe our path to value creation is clear and visible, supported by:

- The economy, our markets and our product;
- A sector-leading development program;
- A well-positioned capital structure; and
- A "cycle-seasoned" management team.

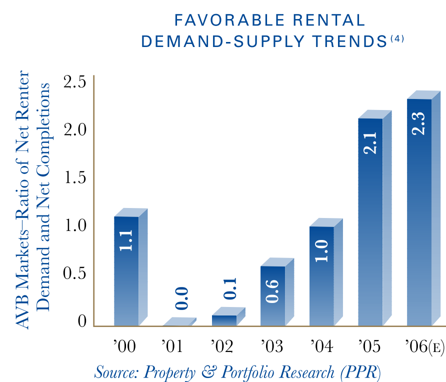
These attributes position us for growth and are discussed further in the remainder of this letter.

Positioned for Growth — the Economy, Our Markets and Our Product

Key economic forecasts suggest continued economic and employment growth. In addition, the outlook for industry liquidity is favorable, with no signs that abundant access to capital—debt and equity, public and private—is abating.

Forecasts for economic, employment and population growth within our markets translate into continued strengthening of demand and supply fundamentals, which should help support the strongest rental revenue growth since 2001.

FAVORABLE RENTAL DEMAND-SUPPLY TRENDS (4)



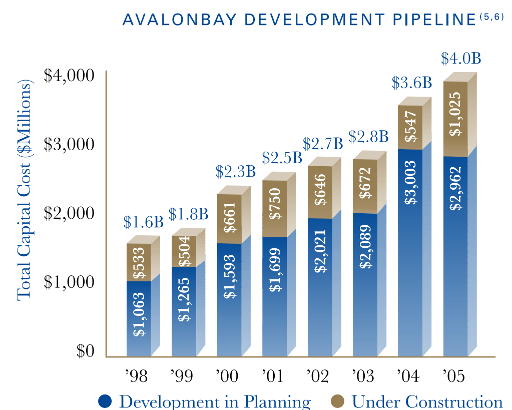
Source: Property & Portfolio Research (PPR)

The same forecasts that support improving apartment fundamentals generally support all housing—including the for-sale market. However, shifting demographics, the gap in "rent vs. buy" economics and softening home sales suggest that home ownership levels may have reached a plateau, with the relative balance between for-sale and for-rent housing demand shifting back in favor of rental housing. Given our market concentration, asset quality and product diversity, AvalonBay is well positioned to benefit from improving fundamentals. With products designed to appeal to a broad

range of prospective residents and a portfolio that is highly occupied, we expect to see revenue growth from our existing assets *and* from an accelerated pace of new development leasing. The acceleration of revenue growth in late 2005 should continue into 2006 at levels of 5 to 6 percent—the highest in five years.

Positioned for Growth—a Sector-Leading Development Program

This positive outlook supports our operating, development and capital recycling programs. Our Development Pipeline now stands at $4 billion, comprised of $1 billion under construction and $3 billion in planning. This is the largest development program in the multifamily sector. With an average land basis per unit of approximately $35,000 and access to attractive capital sources to fund the pipeline, we expect future development activity to contribute to earnings growth for years to come. Adding to the pipeline is challenging, as competing for fully entitled land against for-sale developers is just plain not economic. We responded to this challenge with creative thinking while taking measured risk, successfully adding a diverse set of new opportunities:



- In the greater Boston area, we acquired a 300-acre site of a former state hospital, gaining entitlements for apartment, condominium, retail and office uses while preserving many of the historically significant architectural features of the structure.
- In New York City, we undertook a multi-million dollar environmental remediation effort to begin construction of a $170 million high-rise apartment community adjacent to our successful Avalon Riverview community.
- In the greater Washington DC market, we acquired several commercial properties that we intend to re-zone and raze for development of new apartments, providing cash flow from leases in place while controlling the land and advancing the entitlement process.

AVALON BELLEVUE, WA

AVALON AT FOXHALL, DC

Opportunities such as these are created by having an established local presence in each of our supply-constrained markets. We have over a hundred experienced construction and development professionals in ten regional offices dedicated to identifying and executing development opportunities—local execution with centralized support.

Significant challenges facing the industry include higher replacement costs from general cost escalation and scarce subcontractor resources, which add complexity and risk to new development. These challenges require increased vigilance on our part to contain cost increases, and we have an organization of experienced professionals, market tenure and economies of scale which help insulate us from these pressures.

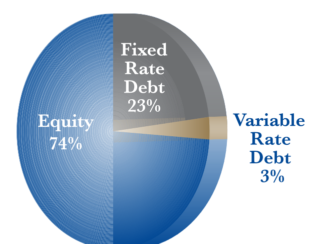
After more than twenty years in our markets, we have developed a unique infrastructure of development, investment and property management skills. This translates into a competitive advantage in markets that are difficult to penetrate and where new entitlements are not easy to obtain. Higher replacement costs mentioned above do serve to limit competition, emphasizing the value of our $9 billion of operating assets in place as well as land under control, further enhancing our competitive advantage.

The value creation from our development activity is not captured in our balance sheet or earnings today, but will accrue to the benefit of investors as these developments move through the pipeline.

Positioned for Growth—a Well-Positioned Capital Structure Prepared for External Growth

Our $4 billion Development Pipeline is an important source of future earnings growth and value creation, and we believe our balance sheet will continue to support that growth. With current Fixed Charge Coverage and Leverage of 3.0x and 26 percent, respectively, we have significant borrowing capacity to develop this backlog of business in a prudent manner. Low levels of floating rate debt help ensure that

CAPITAL STRUCTURE[7]

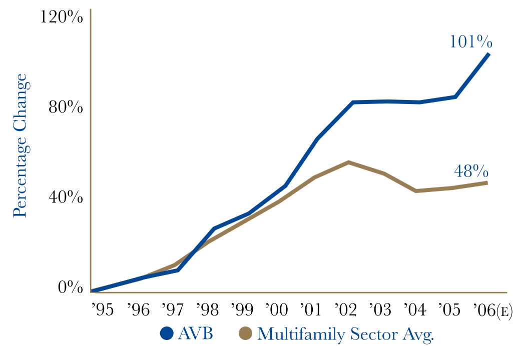


AVALON AT ROCK SPRING, MD

AVALON AT FLANDERS HILL, MA

future earnings growth will not be "taxed" with higher interest rates. Retained cash levels continue to rise, providing cost-effective development capital and room for additional dividend growth. Recognizing the prospects for future earnings growth, our board voted to increase the annual dividend by 10 percent, from $2.84 to $3.12 per share effective March 2006. This represents the largest percentage increase in the sector and is fully supported by recurring cash flow. Long-term growth and safety of the dividend is also our focus. Since 1995, the growth in our recurring dividend was twice the multifamily sector average. This was acheived while maintaining one of the lowest payout ratios in the sector.

COMMON DIVIDEND PER SHARE GROWTH[8]



Source: Company Reports

We've prepared the balance sheet for accretive development, but recognize that value can also be created through selective capital allocation to acquisitions. Accordingly, we further positioned for growth through private equity, creating the AvalonBay Value Added Fund, L.P. This investment management fund provides enough equity capital to purchase and leverage investments totaling $900 million. This approach provides access to an alternative capital source, is consistent with our desire to keep our common stock scarce and presents an opportunity to create value for private investors. Investment management also provides an attractive and recurring income stream for our management efforts.

A well-executed capital allocation strategy creates value. Access to multiple capital sources allows us to direct public equity to more accretive development while directing private equity to acquisitions. This helps ensure optimal value creation from our capital allocation efforts.

AVALON AT NEWTON HIGHLANDS, MA

AVALON ON THE SOUND, NY

Positioned for Growth—a "Cycle-Seasoned" Management Team

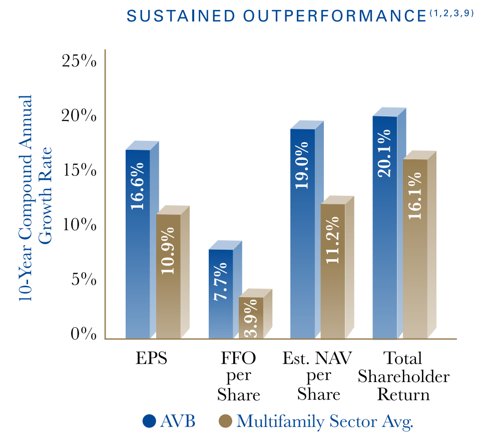
The period from 2002-2004 that marked a severe downturn in operating fundamentals was difficult but instructive. We learned and adapted tactics to optimize performance, but our time-tested strategy remained intact. Convinced our strategy was sound, we positioned the company for the upturn—installing new systems, streamlining processes, adjusting our development and construction infrastructure to match current and prospective opportunities, and preparing the balance sheet for the next up-cycle.

We weathered the storm well, with a stock price double its pre-downturn level, a positive outlook from the rating agencies and a seasoned group of professional management that understands how to maximize value during all phases of a real estate cycle.

CONCLUSION

Our 2005 results are part of a recurring theme of general outperformance over a sustained period of time, as AvalonBay outperformed the sector in EPS, FFO per Share, NAV per Share Growth and Total Shareholder Return over the last 10 years. And many of the attributes that drove significant shareholder value creation over this 10-year period remain in place.

SUSTAINED OUTPERFORMANCE[1,2,3,9]



Source: SNL Financial; Bloomberg; Green Street Advisors, Inc.

Today, apartment fundamentals are improving, with third-party economic forecasts calling for continued economic and employment growth. Many of our markets are projected to outperform, with revenue growth in 2006 at the highest levels since 2001. Rental rates are rising, and future revenue growth is supported by the high occupancy platform we currently enjoy. Leasing activity at our development communities is strong.

AVALON AT GALLERY PLACE, DC

AVALON AT ARLINGTON SQUARE, VA

We are positioned for growth. We have a time-tested strategy that has delivered outsized risk-adjusted returns over an extended period. We have a competitive advantage in our development program in some of the strongest markets in the country. We have a high-quality and diverse offering of apartment homes that will be in demand as economic growth continues. We have an integrated real estate operating platform poised for additional value creation as we build out and add to our $4 billion pipeline. We have a well-positioned balance sheet that supports growth. Finally, we have a "cycle-seasoned" management team that is committed to our strategy, but nimble enough to make adjustments when opportunities arise. And although our strategy will evolve, it will not drift. We remain committed to these core elements of our time-tested strategy:

- To further penetrate our supply-constrained markets that offer strong long-term fundamentals;
- To create value through pursuit of ground-up development of land for which we gain entitlements;
- To effectively allocate capital through targeted acquisition and disposition activity;
- To optimize our operating portfolio while delivering exceptional service to our residents; and
- To maintain a financial position that supports and maximizes value creation.

As always, I would like to thank our shareholders for their support, our associates for another year of outstanding achievements and our residents for making an AvalonBay community their home.

Bryce Blair
Chairman and
Chief Executive Officer

Notes & Non-GAAP Financial Measures and Other Terms

NOTES

1. Total Shareholder Return—The change in value over the period stated with all dividends reinvested. Total Shareholder Return is sometimes presented as the compound annual growth rate. The Total Shareholder Return for each year within the timeframe presented may vary.
2. Estimated NAV per Share Growth—The compound annual growth rate of Estimated NAV per Share as estimated by Green Street Advisors, Inc. during the periods indicated. Estimated NAV per Share Growth for each year within the timeframe presented may vary.
3. FFO per Share Growth—The compound annual growth rate of FFO per Share as reported during the period stated. FFO per Share Growth for each year within the timeframe presented may vary.
4. Data provided by PPR. Demand-supply defined as the ratio of net renter demand and net completions. Net renter demand is defined as the year-to-year change in the total rental population. Net completions is defined as the year-to-year change in rental completions net of condominium conversions.
5. Development Pipeline—The projected Total Capital Cost for Development in Planning plus the projected Total Capital Cost of communities under construction. Amounts represent the Development Pipeline at December 31 of each year presented.
6. Development in Planning (Development Rights)—Development opportunities in the early phase of the development process for which: (i) we have an option to acquire land or enter into a leasehold interest; (ii) we are the buyer under a long-term conditional contract to purchase land; or (iii) we own land to develop a new community. The dollar amount for Development in Planning represents the projected Total Capital Cost if these opportunities were developed as anticipated.
7. Percentages for Equity and Fixed and Variable Rate Debt represent the dollar amounts for each as a percentage of the Company's Total Market Capitalization at December 31, 2005. Total Market Capitalization represents the aggregate of the market value of the Company's common stock, the market value of the Company's operating partnership units outstanding (based on the market value of the Company's common stock), the liquidation preference of the Company's preferred stock and the outstanding principal balance of the Company's debt.
8. Common Dividend per Share Growth—The increase in common dividends per share distributed during the period stated. The common dividend per share for 2006 reflects the annualized first quarter 2006 dividend per share for all companies that have declared a first quarter 2006 dividend and reflects the annualized fourth quarter 2005 dividend for all others.
9. EPS Growth—The compound annual growth rate of EPS during the period stated. EPS Growth for each year within the timeframe presented may vary.

NON-GAAP FINANCIAL MEASURES AND OTHER TERMS

The following non-GAAP financial measures and other terms, as used in this Annual Report, including the Letter to Shareholders, are defined and further explained herein on pages 63-66 in the section titled "Definitions and Reconciliations of Non-GAAP Financial Measures and Other Terms":

- Economic Gain
- Estimated Net Asset Value (NAV) per Share
- Fixed Charge Coverage (Interest Coverage)
- Funds from Operations (FFO)
- Initial Year Market Capitalization Rate (Cap Rate)
- Leverage
- Multifamily Sector Average
- Net Operating Income (NOI)
- Same Store (Established) Communities
- Total Capital Cost
- Unleveraged IRR

FORWARD-LOOKING STATEMENTS

This Annual Report, including the Letter to Shareholders, contains "forward-looking statements" within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934. Please see our discussion titled "Forward-Looking Statements" on page 32 of this report for a discussion regarding risks associated with these statements.

The following table provides historical consolidated financial, operating and other data for AvalonBay Communities, Inc. You should read the table with our Consolidated Financial Statements and the Notes included in this report.

	For the year ended				
(Dollars in thousands, except per share information)	12-31-05	12-31-04	12-31-03	12-31-02	12-31-01
Revenue:					
Rental and other income	$ 666,376	$ 613,240	$ 556,582	$ 531,595	$ 521,805
Management, development and other fees	4,304	604	931	2,145	1,386
Total revenue	670,680	613,844	557,513	533,740	523,191
Expenses:					
Operating expenses, excluding property taxes	191,558	181,351	164,253	147,965	133,352
Property taxes	65,487	59,458	53,257	47,580	43,178
Interest expense	127,099	131,103	130,178	114,282	92,597
Depreciation expense	158,822	151,991	138,725	121,995	106,670
General and administrative expense	25,761	18,074	14,830	13,449	14,705
Impairment loss	—	—	—	6,800	—
Total expenses	568,727	541,977	501,243	452,071	390,502
Equity in income of unconsolidated entities	7,198	1,100	25,535	55	856
Venture partner interest in profit-sharing	—	(1,178)	(1,688)	(857)	1,158
Minority interest in consolidated partnerships	(1,481)	(150)	(950)	(865)	(948)
Income before gain on sale of real estate assets	107,670	71,639	79,167	80,002	133,755
Gain on sale of real estate assets	—	—	—	—	62,852
Income from continuing operations before cumulative effect of change in accounting principle	107,670	71,639	79,167	80,002	196,607
Discontinued operations:					
Income from discontinued operations	14,942	21,134	31,368	44,723	52,390
Gain on sale of real estate assets	199,766	122,425	160,990	48,893	—
Total discontinued operations	214,708	143,559	192,358	93,616	52,390
Income before cumulative effect of change in accounting principle	322,378	215,198	271,525	173,618	248,997
Cumulative effect of change in accounting principle	—	4,547	—	—	—
Net income	322,378	219,745	271,525	173,618	248,997
Dividends attributable to preferred stock	(8,700)	(8,700)	(10,744)	(17,896)	(40,035)
Net income available to common stockholders	$ 313,678	$ 211,045	$ 260,781	$ 155,722	$ 208,962
Per Common Share and Share Information:					
Earnings per common share—basic					
Income from continuing operations (net of dividends attributable to preferred stock)	$ 1.36	$ 0.94	$ 1.00	$ 0.90	$ 1.38
Discontinued operations	$ 2.94	$ 2.01	$ 2.80	$ 1.36	$ 1.70
Net income available to common stockholders	$ 4.30	$ 2.95	$ 3.80	$ 2.26	$ 3.08
Weighted average common shares outstanding—basic	72,952,492	71,564,202	68,559,657	68,772,139	67,842,752
Earnings per common share—diluted					
Income from continuing operations (net of dividends attributable to preferred stock)	$ 1.34	$ 0.94	$ 0.99	$ 0.89	$ 1.36
Discontinued operations	$ 2.87	$ 1.98	$ 2.74	$ 1.34	$ 1.66
Net income available to common stockholders	$ 4.21	$ 2.92	$ 3.73	$ 2.23	$ 3.02
Weighted average common shares outstanding—diluted	74,759,318	73,354,956	70,203,467	70,674,211	69,781,719
Cash dividends declared	$ 2.84	$ 2.80	$ 2.80	$ 2.80	$ 2.56

	For the year ended				
	12-31-05	12-31-04	12-31-03	12-31-02	12-31-01
Other Information:					
Net income	$ 322,378	$ 219,745	$ 271,525	$ 173,618	$ 248,997
Depreciation—continuing operations	158,822	151,991	138,725	121,995	106,670
Depreciation—discontinued operations	3,241	10,676	15,071	22,482	23,409
Interest expense, net—continuing operations	127,099	131,103	130,178	114,282	92,597
Interest expense, net—discontinued operations	—	525	2,399	3,122	3,783
EBITDA [1]	$ 611,540	$ 514,040	$ 557,898	$ 435,499	$ 475,456
Funds from Operations [2]	$ 281,773	$ 246,247	$ 230,566	$ 251,410	$ 275,755
Number of Current Communities [3]	143	138	131	137	126
Number of apartment homes	41,412	40,142	38,504	40,179	37,228
Balance Sheet Information:					
Real estate, before accumulated depreciation	$5,903,168	$5,697,144	$5,431,757	$5,369,453	$4,837,869
Total assets	$5,165,060	$5,081,249	$4,909,582	$4,950,835	$4,664,289
Notes payable and unsecured credit facilities	$2,366,564	$2,451,354	$2,337,817	$2,471,163	$2,082,769
Cash Flow Information:					
Net cash flows provided by operating activities	$ 306,639	$ 275,617	$ 239,677	$ 307,810	$ 320,528
Net cash flows provided by (used in) investing activities	$ (19,761)	$ (251,683)	$ 33,935	$ (435,796)	$ (274,941)
Net cash flows provided by (used in) financing activities	$ (282,293)	$ (29,471)	$ (279,465)	$ 68,008	$ (29,909)

Notes to Selected Financial Data

(1) EBITDA is defined by us as net income before interest income and expense, income taxes, depreciation and amortization from both continuing and discontinued operations. Under this definition, which complies with the rules and regulations of the Securities and Exchange Commission, EBITDA includes gains on sale of assets and gain on sale of partnership interests. Management generally considers EBITDA to be an appropriate supplemental measure to net income of our operating performance because it helps investors to understand our ability to incur and service debt and to make capital expenditures. EBITDA should not be considered as an alternative to net income (as determined in accordance with generally accepted accounting principles, or "GAAP"), as an indicator of our operating performance, or to cash flows from operating activities (as determined in accordance with GAAP) as a measure of liquidity. Our calculation of EBITDA may not be comparable to EBITDA as calculated by other companies.

(2) We generally consider Funds from Operations, or "FFO," to be an appropriate supplemental measure of our operating and financial performance because, by excluding gains or losses related to dispositions of previously depreciated property and excluding real estate depreciation, which can vary among owners of identical assets in similar condition based on historical cost accounting and useful life estimates, FFO can help one compare the operating performance of a real estate company between periods or as compared to different companies. We believe that in order to understand our operating results, FFO should be examined with net income as presented in the Consolidated Statements of Operations and Other Comprehensive Income included elsewhere in this report.

Consistent with the definition adopted by the Board of Governors of the National Association of Real Estate Investment Trusts®, ("NAREIT"), we calculate FFO as net income or loss computed in accordance with GAAP, adjusted for:

- gains or losses on sales of previously depreciated operating communities;
- extraordinary gains or losses (as defined by GAAP);
- cumulative effect of change in accounting principle;
- depreciation of real estate assets; and
- adjustments for unconsolidated partnerships and joint ventures.

FFO does not represent net income in accordance with GAAP, and therefore it should not be considered an alternative to net income, which remains the primary measure, as an indication of our performance. In addition, FFO as calculated by other REITs may not be comparable to our calculation of FFO. The following is a reconciliation of net income to FFO:

	For the year ended				
(dollars in thousands, except per share data)	12-31-05	12-31-04	12-31-03	12-31-02	12-31-01
Net income	$ 322,378	$ 219,745	$ 271,525	$ 173,618	$ 248,997
Dividends attributable to preferred stock	(8,700)	(8,700)	(10,744)	(17,896)	(40,035)
Depreciation—real estate assets, including discontinued operations and joint venture adjustments	162,019	157,988	128,278	142,980	128,086
Minority interest expense, including discontinued operations	1,363	3,048	1,263	1,601	1,559
Cumulative effect of change in accounting principle	—	(4,547)	—	—	—
Gain on sale of previously depreciated real estate assets	(195,287)	(121,287)	(159,756)	(48,893)	(62,852)
Funds from Operations attributable to common stockholders	$ 281,773	$ 246,247	$ 230,566	$ 251,410	$ 275,755
Weighted average common shares outstanding—diluted	74,759,318	73,354,956	70,203,467	70,674,211	69,781,719
FFO per common share—diluted	$ 3.77	$ 3.36	$ 3.28	$ 3.55	$ 3.95

FFO also does not represent cash generated from operating activities in accordance with GAAP, and therefore should not be considered an alternative to net cash flows from operating activities, as determined by GAAP, as a measure of liquidity. Additionally, it is not necessarily indicative of cash available to fund cash needs. A presentation of GAAP based cash flow metrics is provided in "Cash Flow Information" in the table above.

(3) Current Communities consist of all communities other than those which are still under construction and have not received a certificate of occupancy.

We are primarily engaged in developing, acquiring, owning and operating apartment communities in high barrier-to-entry markets of the United States. We seek to create long-term shareholder value by accessing capital on cost effective terms; deploying that capital to develop, redevelop and acquire apartment communities in high barrier-to-entry markets; operating apartment communities; and selling communities when they no longer meet our long-term investment strategy and when pricing is attractive.

The net operating income of our current operating communities, as defined later in this report, is one of the financial measures that we use to evaluate community performance. Net operating income is affected by the demand and supply dynamics within our markets, our rental rates and occupancy levels, and our ability to control operating costs. Our overall financial performance is also impacted by the general availability and cost of capital and the performance of our newly developed and acquired apartment communities.

This report, including the following discussion and analysis of our financial condition and results of operations, contains forward-looking statements regarding future events or trends as described more fully under "Forward-Looking Statements" on page 32 of this report. Actual results or developments could differ materially from those projected in such statements. The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our Consolidated Financial Statements and notes included elsewhere in this report.

Business Description and Community Information Overview

We believe that apartment communities present an attractive long-term investment opportunity compared to other real estate investments because a broad potential resident base should help reduce demand volatility over a real estate cycle. We intend to continue to pursue real estate investments in markets where constraints to new supply exist, and where new rental household formations are expected to out-pace multifamily permit activity over the course of the real estate cycle. Barriers-to-entry in our markets generally include a difficult and lengthy entitlement process with local jurisdictions and dense urban or suburban areas where zoned and entitled land is in limited supply.

We regularly evaluate the allocation of our investments by the amount of invested capital and by product type within our individual markets, which are located in the Northeast, Mid-Atlantic, Midwest, Pacific Northwest, and Northern and Southern California regions of the United States. Our strategy is to more deeply penetrate these markets with a broad range of products and services and an intense focus on our customer. A substantial majority of our communities are upscale, which generally command among the highest rents in their markets. However, we also pursue the ownership and operation of apartment communities that target a variety of customer segments and price points, consistent with our goal of offering a broad range of products and services.

We believe that, over an entire real estate cycle, lower housing affordability and the limited new supply of apartment homes in our markets will result in a higher propensity to rent and larger increases in cash flow relative to other markets. However, throughout the real estate cycle, apartment market fundamentals, and therefore operating cash flows, are affected by overall economic conditions. A number of our markets experienced economic contraction due to job losses in 2002 and 2003, particularly in the technology, telecom and financial services sectors. This resulted in a prolonged period of weak apartment market fundamentals as reflected in declining rental rates and demand. However, 2004 was a year of transition, where the economy showed signs of an early phase recovery, as evidenced by modest job growth and declining unemployment claims. The improvement in the economic environment in 2005 has resulted in stronger apartment market fundamentals.

This is supported by the following operating results achieved within our Established Community portfolio during 2005:

- we achieved year-over-year revenue growth;
- we transitioned from occupancy gains to increases in rental rates as the primary driver of rental revenue growth;
- we achieved the highest year-over-year increase in average rental rates in four years; and
- average economic occupancy was at or above 95% in each of our markets.

Based on these results and our expectations for improving demand/supply fundamentals, we expect continued growth in the revenue and net operating income generated by our operating communities in 2006. We expect continued job growth and household formation in our markets in 2006, the principal drivers of housing demand. Condominium conversion activity has

reduced the availability of rental apartments, while low single-family home affordability makes rental apartments an economically attractive housing alternative. Accordingly, we expect apartment market fundamentals to continue to improve in our markets such that apartment rental demand will outpace new supply, resulting in rental revenue growth of 5.0% to 6.0% in our Established Community portfolio in 2006, and projected NOI growth of 6.0% to 7.0%.

In positioning for future growth, we increased our development volume. We currently have in excess of $1,000,000,000 under construction (measured by total projected capitalized cost of the communities at completion, including the portions owned by joint venture partners). In addition, we continue to secure new Development Rights, as discussed below, including the acquisition of land for future development. We currently have Development Rights for construction of new apartment communities that, based on total projected capitalized cost, total approximately $3,000,000,000. We anticipate starting new developments with total projected capitalized costs of $700,000,000 to $800,000,000 in 2006. These total projected capitalized costs may be impacted by increasing construction costs, particularly in the areas of payroll, utilities, concrete and steel. We also anticipate acquiring additional land held for future development for an aggregate purchase price of $75,000,000 to $100,000,000.

We continue to look for opportunities to acquire existing communities through our investment in and management of a discretionary investment fund (the “Fund”). During its investment period (which will end on or before March 16, 2008), the Fund will be our exclusive vehicle for acquiring apartment communities, subject to certain exceptions. The Fund acquired four communities for an aggregate purchase price of $99,907,000 during 2005 and has approximately $90,000,000 under contract for acquisition in early 2006. We will continue to focus on acquisition opportunities where we believe we can create value, generally through redevelopment or repositioning opportunities.

Strong capital flows to the industry and the strength of the condominium market have resulted in an attractive selling environment. We sold seven communities during 2005 for an aggregate sales price of approximately $350,000,000, of which approximately $315,000,000 was sold to condominium converters. We anticipate asset sales of approximately $225,000,000 to $300,000,000 in 2006.

While the active condominium market has created demand for multifamily apartment communities, it has also created a challenging environment for us in other ways such as:

- increased competition for land, resulting in, at times, the acquisition of land zoned for uses other than residential with the potential for rezoning;
- increased competition for subcontractors;
- increased competition for experienced multifamily development and construction professionals, particularly in our markets;
- increased competition for our customers, resulting in increased move-outs due to home ownership; and
- increased risks as a result of sales to condominium converters.

There are indications that condominium conversion activity is slowing, which could impact the market for our assets held for sale, and as a result, the volume of assets we offer for sale.

Our real estate investments consist primarily of current operating apartment communities, communities in various stages of development (“Development Communities”) and Development Rights (i.e., land or land options held for development). Our current operating communities are further distinguished as Established Communities, Other Stabilized Communities, Lease-Up Communities and Redevelopment Communities. Established Communities are generally operating communities that are consolidated for financial reporting purposes and were owned and had stabilized occupancy and operating expenses as of the beginning of the prior year, which allows the performance of these communities and the markets in which they are located to be compared and monitored between years. Other Stabilized Communities are generally all other operating communities that have stabilized occupancy and operating expenses as of the beginning of the current year, but had not achieved stabilization as of the beginning of the prior year. Lease-Up Communities consist of communities where construction is complete but stabilization has not been achieved. Redevelopment Communities consist of communities where substantial redevelopment is in progress or is planned to begin during the current year. A more detailed description of our reportable segments and other related operating information can be found in Note 9, “Segment Reporting,” of our Consolidated Financial Statements.

Although each of these categories is important to our business, we generally evaluate overall operating, industry and market trends based on the operating results of Established Communities, for which a detailed discussion can be found in "Results of Operations" as part of our discussion of overall operating results. We evaluate our current and future cash needs and future operating potential based on acquisition, disposition, development, redevelopment and financing activities within Other Stabilized, Redevelopment and Development Communities, for which detailed discussions can be found in "Liquidity and Capital Resources."

As of December 31, 2005, we owned or held an ownership interest in 158 apartment communities containing 45,474 apartment homes in ten states and the District of Columbia, of which 15 communities were under construction and two communities were under reconstruction. In addition, we owned a direct or indirect ownership interest in Development Rights to develop an additional 47 communities that, if developed in the manner expected, will contain an estimated 12,495 apartment homes.

Critical Accounting Policies

The preparation of financial statements in conformity with generally accepted accounting principles ("GAAP") requires management to use judgment in the application of accounting policies, including making estimates and assumptions. If our judgment or interpretation of the facts and circumstances relating to various transactions had been different, or different estimates or assumptions had been made, it is possible that different accounting policies would have been applied, resulting in different financial results or a different presentation of our financial statements. Below is a discussion of accounting policies that we consider critical to an understanding of our financial condition and operating results and that may require complex judgment in their application or require estimates about matters which are inherently uncertain. As a REIT that owns, operates and develops apartment communities, our critical accounting policies relate to revenue recognition, cost capitalization, asset impairment evaluation and REIT status. A discussion of our significant accounting policies, including further discussion of the accounting policies described below, can be found in Note 1, "Organization and Significant Accounting Policies" of our Consolidated Financial Statements.

Revenue Recognition Rental income related to leases is recognized on an accrual basis when due from residents in accordance with SEC Staff Accounting Bulletin No. 104, "Revenue Recognition" and Statement of Financial Accounting Standards No. 13, "Accounting for Leases." In accordance with our standard lease terms, rental payments are generally due on a monthly basis. Any cash concessions given at the inception of the lease are amortized over the approximate life of the lease, which is generally one year. A discussion regarding the impact of cash concessions on rental revenue for Established Communities can be found in "Results of Operations."

Cost Capitalization We capitalize costs during the development of assets (including interest and related loan fees, property taxes and other direct and indirect costs) beginning when development efforts commence until the asset, or a portion of the asset, is delivered and is ready for its intended use, which is generally indicated by the issuance of a certificate of occupancy. We capitalize costs during redevelopment of apartment homes (including interest and related loan fees, property taxes and other direct and indirect costs) beginning when an apartment home is taken out-of-service for redevelopment until the apartment home redevelopment is completed and the apartment home is available for a new resident. Rental income and operating expenses incurred during the initial lease-up or post-redevelopment lease-up period are fully recognized as they accrue.

We capitalize pre-development costs incurred in pursuit of Development Rights for which we currently believe future development is probable. These costs include legal fees, design fees and related overhead costs. Future development of these Development Rights is dependent upon various factors, including zoning and regulatory approval, rental market conditions, construction costs and availability of capital. Pre-development costs incurred in the pursuit of Development Rights for which future development is not yet considered probable are expensed as incurred. In addition, if the status of a Development Right changes, making future development no longer probable, any capitalized pre-development costs are written-off with a charge to expense.

We generally capitalize only non-recurring expenditures. We capitalize improvements and upgrades only if the item: (i) exceeds $15,000; (ii) extends the useful life of the asset; and (iii) is not related to making an apartment home ready for the next resident. Under this policy, virtually all capitalized costs are non-recurring, as recurring make-ready costs are expensed as incurred. Recurring make-ready costs include: (i) carpet and appliance replacements; (ii) floor coverings; (iii) interior painting; and (iv) other redecorating costs. Because we expense recurring make-ready costs, such as carpet replacements, our expense levels and volatility are greatest in the third quarter of each year as this is when we experience our greatest amount of turnover. We capitalize purchases of personal property, such as computers and furniture, only if the item is a new addition and the item exceeds $2,500. We generally expense replacements of personal property.

In 2005, 2004 and 2003, the amounts capitalized (excluding land costs) related to acquisitions, development and redevelopment were $425,170,000, $347,091,000 and $296,764,000, respectively. For Established and Other Stabilized Communities, we recorded non-revenue generating capital expenditures of $16,753,000 or $471 per apartment home in 2005, $12,347,000 or $354 per apartment home in 2004 and $11,064,000 or $333 per apartment home in 2003. In addition, revenue generating capital expenditures, such as water submetering equipment and cable installations, were $817,000, $637,000 and $529,000 in 2005, 2004 and 2003, respectively. The average maintenance costs charged to expense per apartment home, including carpet and appliance replacements, related to these communities was $1,546 in 2005, $1,348 in 2004 and $1,262 in 2003. Historically, we have experienced a gradual increase in capitalized costs and expensed maintenance costs per apartment home as the average age of our communities has increased, and expensed maintenance costs have fluctuated with turnover. Although we expect these trends to continue in the future, capitalized costs increased in 2005 over prior year growth levels as we embarked on a number of community upgrades and improvements. We expect capitalized costs in 2006 to be at or slightly above 2005 levels as we continue with these community upgrades and improvements.

Asset Impairment Evaluation If there is an event or change in circumstance that indicates an impairment in the value of a community, our policy is to assess the impairment by making a comparison of the current and projected operating cash flow of the community over its remaining useful life, on an undiscounted basis, to the carrying amount of the community. If the carrying amount is in excess of the estimated projected operating cash flow of the community, we would recognize an impairment loss equivalent to an amount required to adjust the carrying amount to its estimated fair market value. Real estate assets held for sale are measured at the lower of the carrying amount or the fair value less the cost to sell.

We account for our investments in unconsolidated entities that were created prior to and have not been modified since June 29, 2005, and are not variable interest entities in accordance with Statement of Position 78-9, "Accounting for Investments in Real Estate Ventures" and Accounting Principles Board Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock." Any investments in entities that were created or modified subsequent to June 29, 2005, and are not variable interest entities are accounted for in accordance with EITF Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights." If there is an event or change in circumstance that indicates a loss in the value of an investment, we record the loss and reduce the value of the investment to its fair value. A loss in value would be indicated if we could not recover the carrying value of the investment or if the investee could not sustain an earnings capacity that would justify the carrying amount of the investment.

REIT Status We are a Maryland corporation that has elected to be treated, for federal income tax purposes, as a REIT. We elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended, for the year ended December 31, 1994 and have not revoked such election. A corporate REIT is a legal entity which holds real estate interests and must meet a number of organizational and operational requirements, including a requirement that it currently distribute at least 90% of its adjusted taxable income to stockholders. As a REIT, we generally will not be subject to corporate level federal income tax on taxable income we distribute currently to our stockholders. If we fail to qualify as a REIT in any taxable year, we will be subject to federal income taxes at regular corporate rates (subject to any applicable alternative minimum tax) and may not be able to elect to qualify as a REIT for four subsequent taxable years.

Results of Operations

Our year-over-year operating performance is primarily affected by changes in net operating income of our current operating apartment communities due to: market conditions; net operating income derived from acquisitions and development completions; the loss of net operating income related to disposed communities; and capital market, disposition and financing activity. A comparison of our operating results for the years 2005, 2004 and 2003 follows:

(dollars in thousands)	**2005**	2004	Change $	Change %	2004	2003	Change $	Change %
Revenue:								
Rental and other income	$666,376	$613,240	$ 53,136	8.7%	$613,240	$556,582	$ 56,658	10.2%
Management, development and other fees	4,304	604	3,700	612.6%	604	931	(327)	(35.1%)
Total revenue	670,680	613,844	56,836	9.3%	613,844	557,513	56,331	10.1%
Expenses:								
Direct property operating expenses, excluding property taxes	155,481	148,705	6,776	4.6%	148,705	134,182	14,623	10.8%
Property taxes	65,487	59,458	6,029	10.1%	59,458	53,257	6,201	11.6%
Total community operating expenses	220,968	208,163	12,805	6.2%	208,163	187,439	20,724	11.1%
Corporate-level property management and other indirect operating expenses	31,243	27,956	3,287	11.8%	27,956	27,123	833	3.1%
Investments and investment management	4,834	4,690	144	3.1%	4,690	2,948	1,742	59.1%
Interest expense, net	127,099	131,103	(4,004)	(3.1%)	131,103	130,178	925	0.7%
Depreciation expense	158,822	151,991	6,831	4.5%	151,991	138,725	13,266	9.6%
General and administrative expense	25,761	18,074	7,687	42.5%	18,074	14,830	3,244	21.9%
Total other expenses	347,759	333,814	13,945	4.2%	333,814	313,804	20,010	6.4%
Equity in income of unconsolidated entities	7,198	1,100	6,098	554.4%	1,100	25,535	(24,435)	n/a
Venture partner interest in profit-sharing	—	(1,178)	1,178	(100.0%)	(1,178)	(1,688)	510	(30.2%)
Minority interest in consolidated partnerships	(1,481)	(150)	(1,331)	887.3%	(150)	(950)	800	(84.2%)
Income from continuing operations before cumulative effect of change in accounting principle	107,670	71,639	36,031	50.3%	71,639	79,167	(7,528)	(9.5%)
Discontinued operations:								
Income from discontinued operations	14,942	21,134	(6,192)	(29.3%)	21,134	31,368	(10,234)	(32.6%)
Gain on sale of real estate assets	199,766	122,425	77,341	63.2%	122,425	160,990	(38,565)	(24.0%)
Total discontinued operations	214,708	143,559	71,149	49.6%	143,559	192,358	(48,799)	(25.4%)
Income before cumulative effect of change in accounting principle	322,378	215,198	107,180	49.8%	215,198	271,525	(56,327)	(20.7%)
Cumulative effect of change in accounting principle	—	4,547	(4,547)	(100.0%)	4,547	—	4,547	100.0%
Net income	322,378	219,745	102,633	46.7%	219,745	271,525	(51,780)	(19.1%)
Dividends attributable to preferred stock	(8,700)	(8,700)	—	—	(8,700)	(10,744)	2,044	(19.0%)
Net income available to common stockholders	$313,678	$211,045	$102,633	48.6%	$211,045	$260,781	$(49,736)	(19.1%)

Net income available to common stockholders increased $102,633,000, or 48.6%, to $313,678,000 in 2005. This increase is primarily attributable to higher gains on sales of assets in 2005, including the gain related to the sale of a technology investment, as well as increased net operating income from Established Communities and newly developed communities. Net income available to common stockholders decreased $49,736,000, or 19.1%, to $211,045,000 in 2004. This decrease is primarily attributable to lower gains on sales in 2004 as compared to 2003, including the gain realized from an unconsolidated entity, and increased depreciation expense, partially offset by increased net operating income from newly developed and acquired communities.

Net operating income ("NOI") is considered by management to be an important and appropriate supplemental performance measure to net income because it helps both investors and management to understand the core operations of a community or communities prior to the allocation of any corporate-level or financing-related costs. NOI reflects the operating performance of a community and allows for an easy comparison of the operating performance of individual assets or groups of assets. In addition, because prospective buyers of real estate have different financing and overhead structures, with varying marginal impacts to overhead by acquiring real estate, NOI is considered by many in the real estate industry to be a useful measure for determining the value of a real estate asset or group of assets. We define NOI as total property revenue less direct property operating expenses, including property taxes, and NOI excludes:

- corporate-level income (including management, development and other fees);
- corporate-level property management and other indirect operating expenses;
- investments and investment management costs;
- interest expense, net;
- general and administrative expense;
- equity in income of unconsolidated entities;
- minority interest in consolidated partnerships;
- venture partner interest in profit-sharing;
- depreciation expense;
- gain on sale of real estate assets;
- cumulative effect of change in accounting principle; and
- income from discontinued operations.

NOI does not represent cash generated from operating activities in accordance with GAAP. Therefore, NOI should not be considered an alternative to net income as an indication of our performance. NOI should also not be considered an alternative to net cash flow from operating activities, as determined by GAAP, as a measure of liquidity, nor is NOI necessarily indicative of cash available to fund cash needs. A calculation of NOI for the years ended December 31, 2005, 2004 and 2003, along with a reconciliation to net income for each year, is as follows:

	For the year ended		
(dollars in thousands)	**12-31-05**	12-31-04	12-31-03
Net income	$322,378	$219,745	$271,525
Corporate-level property management and other indirect operating expenses	31,243	27,956	27,123
Corporate-level other income	(4,568)	(1,344)	(1,520)
Investments and investment management	4,834	4,690	2,948
Interest expense, net	127,099	131,103	130,178
General and administrative expense	25,761	18,074	14,830
Equity in income of unconsolidated entities	(7,198)	(1,100)	(25,535)
Minority interest in consolidated partnerships	1,481	150	950
Venture partner interest in profit-sharing	—	1,178	1,688
Depreciation expense	158,822	151,991	138,725
Cumulative effect of change in accounting principle	—	(4,547)	—
Gain on sale of real estate assets	(199,766)	(122,425)	(160,990)
Income from discontinued operations	(14,942)	(21,134)	(31,368)
Net operating income	$445,144	$404,337	$368,554

The NOI increases of $40,807,000 and $35,783,000 in 2005 and 2004, respectively, as compared to the prior years, consist of changes in the following categories:

(dollars in thousands)	**2005 Increase**	2004 Increase (Decrease)[1]
Established Communities	**$13,052**	$(3,363)
Other Stabilized Communities	**3,786**	16,010
Development and Redevelopment Communities	**23,969**	23,136
Total	**$40,807**	$35,783

[1] For purposes of this table, amounts have been restated from amounts previously reported for changes in discontinued operations as described in Note 7, "Discontinued Operations—Real Estate Assets Sold or Held for Sale," of our Consolidated Financial Statements.

The NOI increase in Established Communities in 2005 was largely due to the improved apartment market fundamentals. We maintained average economic occupancy of at least 95% in all regions during the year ended December 31, 2005 and we experienced the first year-over-year increase in rental rates in three years. We reached a transition point in the components of rental revenue growth, shifting from occupancy gains to increases in rental rates. We will continue to seek increases in rental rates by increasing market rents and/or reducing concessions, and we expect revenue growth from our Established Communities of 5.0% to 6.0% in 2006 as compared to 2005. In addition, although we will continue to aggressively manage operating expenses, there is upward pressure on operating expenses from increasing utility, labor and property tax expenses. We expect operating expenses at our Established Communities to increase by 3.0% to 4.0% in 2006 as compared to 2005. Overall, we anticipate growth in NOI from our Established Communities of 6.0% to 7.0% in 2006 as compared to 2005.

The Company has given projected NOI growth in 2006 only for Established Communities and not on a company-wide basis. The Company believes that NOI growth of the Established Communities assists investors in understanding management's estimate of the likely contribution to operations from Established Communities. However, the Company has not provided a projection of NOI growth on a company-wide basis due to the difficulty in projecting the timing of new development starts, dispositions and acquisitions, as well as the complexities involved in projecting the allocation of corporate-level property management overhead, general and administrative costs and interest expense to communities not yet developed, disposed or acquired. NOI growth expected from Established Communities is not a projection of the Company's projected consolidated financial performance or projected cash flow.

Rental and other income increased in 2005 due to increased rental rates and occupancy for our Established Communities, coupled with additional rental income generated from newly developed communities. Rental and other income increased in 2004 due to rental income generated from newly developed and acquired communities, as well as increased occupancy for our Established Communities, partially offset by declines in effective rental rates for our Established Communities. We expect apartment fundamentals to continue to strengthen in 2006.

Overall Portfolio—The weighted average number of occupied apartment homes increased to 36,520 apartment homes for 2005 as compared to 34,540 apartment homes for 2004 and 30,774 apartment homes for 2003. This change is primarily the result of an increase in the overall occupancy rate and increased homes available from newly developed and acquired communities, partially offset by communities sold in 2005 and 2004. The weighted average monthly revenue per occupied apartment home increased to $1,516 in 2005 as compared to $1,477 in 2004 and $1,505 in 2003.

Established Communities—Rental revenue increased $16,523,000, or 3.6%, in 2005 and decreased $1,496,000, or 0.3%, in 2004. The increase in 2005 is due to both increased rental rates and increased economic occupancy as compared to 2004. The decrease in 2004 is due to declining rental rates, partially offset by increased economic occupancy as compared to 2003. For 2005, the weighted average monthly revenue per occupied apartment home increased 2.7% to $1,503 compared to $1,464 in 2004, primarily due to increased market rents and decreased concessions. The average economic occupancy increased from 95.2% in 2004 to 96.1% in 2005. Economic occupancy takes into account the fact that apartment homes of different sizes and locations within a community have different economic impacts on a community's gross revenue. Economic occupancy is defined as gross potential revenue less vacancy loss, as a percentage of gross potential revenue. Gross potential revenue is determined by valuing occupied homes at leased rates and vacant homes at market rents. We expect rental revenue from Established Communities to increase 5.0% to 6.0% in 2006 as compared to 2005.

We experienced increases in Established Communities' rental revenue in all six of our regions in 2005 as compared to 2004. The largest increases in rental revenue were in Southern California, the Pacific Northwest and the Northeast, with increases

of 5.7%, 4.3% and 3.7%, respectively, between years. The Northeast and Northern California regions comprise the majority of our Established Community revenue, and therefore are discussed in more detail below.

The Northeast region represented approximately 35.5% of Established Community rental revenue during 2005. Average rental rates increased 2.2% to $1,892 in 2005 and economic occupancy increased 1.5% during 2005. We expect job growth to improve in the Northeast in 2006, although at a more moderate rate than our other markets. We expect moderate rental rate growth in the Northeast during 2006, with Northern New Jersey leading the region in revenue growth. We expect Boston, Massachusetts to lag the region in revenue growth, as economic recovery is not occurring as quickly as in other areas of the region.

Northern California, which represented approximately 31.0% of Established Community rental revenue during 2005, experienced an increase in rental revenue of 2.8% in 2005 as compared to 2004. Average rental rates increased by 2.1% to $1,448 in 2005, and economic occupancy increased 0.7% to 96.2% in 2005. Although apartment fundamentals have been weak in certain areas of Northern California, particularly in San Jose, California, 2005 was a transition point for the region. We expect Northern California to see continued improvement in apartment fundamentals, driven by accelerating job growth and reduced product in the rental market due to condominium conversion activity. We expect the improving fundamentals to translate into accelerated revenue growth.

In accordance with GAAP, cash concessions are amortized as an offset to rental revenue over the approximate lease term, which is generally one year. As a supplemental measure, we also present rental revenue with concessions stated on a cash basis to help investors evaluate the impact of both current and historical concessions on GAAP based rental revenue and to more readily enable comparisons to revenue as reported by other companies. Rental revenue with concessions stated on a cash basis also allows investors to understand historical trends in cash concessions, as well as current rental market conditions.

The following table reconciles total rental revenue in conformity with GAAP to total rental revenue adjusted to state concessions on a cash basis for our Established Communities for the years ended December 31, 2005 and 2004. Information for the year ended December 31, 2003 is not presented, as Established Community classification is not applicable prior to January 1, 2004. See Note 9, "Segment Reporting," of our Consolidated Financial Statements.

	For the year ended	
(dollars in thousands)	**12-31-05**	12-31-04
Rental revenue (GAAP basis)	$472,367	$455,844
Concessions amortized	17,102	19,127
Concessions granted	(14,835)	(18,891)
Rental revenue adjusted to state concessions on a cash basis	$474,634	$456,080
Year-over-year % change—GAAP revenue	3.6%	n/a
Year-over-year % change—cash concession based revenue	4.1%	n/a

Management, development and other fees increased in 2005 as compared to 2004 due to increased asset management, property management and redevelopment fees earned from the Fund, which was formed in March 2005. In addition, construction and development fees earned from one of our unconsolidated entities in 2005 contributed to increased fee income. We expect fee income to increase in 2006 as compared to 2005 due to a full year of operations of, and an increased number of assets owned by, the Fund.

Direct property operating expenses, excluding property taxes increased in both 2005 and 2004, primarily due to the addition of recently developed and acquired apartment homes.

For Established Communities, direct property operating expenses, excluding property taxes, increased $965,000, or 0.9%, to $104,346,000 in 2005 due primarily to increases in payroll and utility costs, partially offset by decreases in marketing and bad debt expenses. During 2004, operating expenses increased $2,131,000, or 2.2%, due primarily to increased payroll costs, as well as increased make-ready costs associated with increasing occupancy. We expect operating expenses for Established Communities to increase by 3.0% to 4.0% in 2006 as compared to 2005, primarily as a result of continued higher utility expenses and payroll costs. Operating expense growth in 2006 as compared to 2005 will be tempered due to $880,000 of expenses incurred in 2005 for land lease payments that will not be incurred in 2006 due to the exercise of a purchase option.

Property taxes increased in both 2005 and 2004 due to overall higher assessments and the addition of newly developed and redeveloped apartment homes, and are impacted by the size and timing of successful tax appeals in both years.

For Established Communities, property taxes increased in 2005 and 2004 by $1,530,000 and $333,000, respectively, due to overall higher assessments throughout all regions, and are impacted by the size and timing of successful tax appeals in both years. We expect property taxes to continue to increase in 2006 as compared to 2005 as local jurisdictions are expected to continue to seek additional revenue sources to offset budget deficits. However, property taxes may fluctuate due to the timing and size of successful tax appeals. We evaluate property tax increases internally, as well as engage third-party consultants, and appeal increases when appropriate.

Corporate-level property management and other indirect operating expenses increased in 2005 as compared to 2004 due to increased compensation costs, as well as increased costs relating to corporate initiatives, including investments in technology and training. We expect corporate-level property management and other indirect operating expenses to increase in 2006 as compared to 2005 as compensation costs continue to increase.

Investments and investment management reflects the costs incurred related to investment acquisitions, investment management and abandoned pursuit costs, which include the abandonment or impairment of development pursuits, acquisition pursuits, disposition pursuits and technology investments. Investments and investment management increased in 2005 as compared to 2004 due primarily to increased costs incurred in forming and managing the Fund, partially offset by a decrease in abandoned pursuit costs. Investments and investment management increased in 2004 as compared to 2003 due to the costs incurred in preparing for and forming the Fund, increased compensation costs and increased abandoned pursuit costs. We expect investments and investment management costs to increase in 2006 as compared to 2005 as Fund activity increases. Abandoned pursuit costs were $816,000, $1,726,000 and $1,180,000 in 2005, 2004 and 2003, respectively. Abandoned pursuit costs can be volatile, and the costs incurred in any given period may be widely different in future years.

Interest expense, net decreased in 2005 as compared to 2004 primarily due to the repayment of unsecured debt and a partial reissuance at lower interest rates, as well as higher levels of capitalized interest, in connection with our increased development activity, partially offset by overall higher short-term interest rates and higher average outstanding balances on our unsecured credit facility. Interest expense, net increased in 2004 as compared to 2003 primarily due to the interest income related to a participating mortgage note included in interest expense, net in 2003 (as described more fully below), partially offset by the repayment of unsecured debt and reissuance at lower interest rates, overall lower interest rates and lower average outstanding balances on our unsecured credit facility. We expect interest expense, net to decrease during 2006 primarily due to higher levels of capitalized interest resulting from increased development activity, as well as lower average outstanding balances on our unsecured credit facility.

Depreciation expense increased in both 2005 and 2004 primarily due to the completion of development and redevelopment activities.

General and administrative expense ("G&A") increased in 2005 as compared to 2004 as a result of: (i) separation costs of approximately $2,100,000 due to the departure of a senior executive; (ii) the accrual of costs related to various litigation matters of approximately $1,500,000; (iii) increased board of director fees due to the acceleration of equity awards with the resignation of a director due to disability; and (iv) higher compensation costs. G&A increased in 2004 as compared to 2003 as a result of higher compensation costs, increased litigation and settlement costs associated with certain community and corporate matters, and additional corporate governance costs, including costs relating to compliance with the Sarbanes-Oxley Act of 2002. We expect expensed overhead costs, including G&A, corporate-level property management and investments and investment management, to increase from 0.0% to 5.0% in 2006 as compared to 2005.

Equity in income of unconsolidated entities increased in 2005 primarily due to the gain recognized in the amount of $6,252,000 related to the sale of our investment in Rent.com to eBay. Equity in income of unconsolidated entities decreased in 2004 as compared to 2003 primarily due to our 50% share of the gain received on a community sold in 2003 which was accounted for under the equity method.

Venture partner interest in profit-sharing in 2004 and 2003 represented the income allocated to our venture partner in a profit-sharing arrangement as discussed in Note 6, "Investments in Unconsolidated Entities," of our Consolidated Financial Statements. Effective December 2004, we no longer account for our interest in this venture as a profit-sharing arrangement, and therefore during 2005, no income or loss from venture partner interest in profit-sharing was recognized.

Minority interest in consolidated partnerships increased in 2005 and decreased in 2004 due to the consolidation of an entity under FASB Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51," as revised in December 2003. Effective January 1, 2004, we consolidated an entity from which we held a participating mortgage note due to the implementation of FIN 46 as discussed in Note 1, "Organization and Significant Accounting Policies," of our Consolidated Financial Statements. We did not hold an equity interest in this entity, and therefore 100% of the entity's net loss was recognized as minority interest in consolidated partnerships during the year ended December 31, 2004. In October 2004, we received payment in full of the outstanding mortgage note due from this entity. Upon repayment of the mortgage note, our economic interest in this entity ended, and therefore this entity was no longer considered a variable interest entity under FIN 46 and we discontinued consolidation.

Income from discontinued operations represents the net income generated by communities sold during the period from January 1, 2003 through December 31, 2005 or considered held for sale as of December 31, 2005. See Note 7, "Discontinued Operations—Real Estate Assets Sold or Held for Sale" of our Consolidated Financial Statements for additional information. The decreases in 2005 and 2004 are due to the sale of seven communities and one office building in 2005 and five communities in 2004, eliminating the income generated from these assets upon disposition.

Gain on sale of real estate assets increased in 2005 and decreased in 2004 due to the volume and size of dispositions in each year. The amount of gains realized depends on many factors, including the number of communities sold, the size and carrying value of those communities and local market conditions. We expect to continue to sell communities based on overall portfolio allocation needs as well as to respond to market opportunities.

Cumulative effect of change in accounting principle in 2004 is a result of the implementation of FIN 46, discussed above, and represents the difference between the net assets consolidated under FIN 46 and the previously recorded net assets.

Dividends attributable to preferred stock decreased during 2004 primarily as a result of several preferred stock redemptions during 2003.

Funds from Operations Attributable to Common Stockholders ("FFO")

FFO is considered by management to be an appropriate supplemental measure of our operating and financial performance because, by excluding gains or losses related to dispositions of previously depreciated property and excluding real estate depreciation, which can vary among owners of identical assets in similar condition based on historical cost accounting and useful life estimates, FFO can help one compare the operating performance of a real estate company between periods or as compared to different companies. We believe that in order to understand our operating results, FFO should be examined with net income as presented in our Consolidated Financial Statements. For a more detailed discussion and presentation of FFO, see "Selected Financial Data," included elsewhere in this report.

Liquidity and Capital Resources

Factors affecting our liquidity and capital resources are our cash flows from operations, financing activities and investing activities. Operating cash flow has historically been determined by: (i) the number of apartment homes currently owned, (ii) rental rates, (iii) occupancy levels and (iv) operating expenses with respect to apartment homes. The timing, source and amount of cash flow provided by financing activities and used in investing activities are sensitive to the capital markets environment, particularly to changes in interest rates. The timing and type of capital markets activity in which we engage, as well as our plans for development, redevelopment, acquisition and disposition activity, are affected by changes in the capital markets environment, such as changes in interest rates or the availability of cost-effective capital.

We regularly review our liquidity needs, the adequacy of cash flow from operations, and other expected liquidity sources to meet these needs. We believe our principal short-term liquidity needs are to fund:

- normal recurring operating expenses;
- debt service and maturity payments;
- preferred stock dividends and DownREIT partnership unit distributions;
- the minimum dividend payments required to maintain our REIT qualification under the Internal Revenue Code of 1986;
- development and redevelopment activity in which we are currently engaged; and
- capital calls for the Fund as required.

We anticipate that we can fully satisfy these needs from a combination of cash flow provided by operating activities, proceeds from asset dispositions and borrowing capacity under our variable rate unsecured credit facility.

Cash and cash equivalents totaled $6,106,000 at December 31, 2005, an increase of $4,585,000 from $1,521,000 at December 31, 2004. The following discussion relates to changes in cash due to operating, investing and financing activities, which are presented in our Consolidated Statements of Cash Flows included elsewhere in this report.

Operating Activities—Net cash provided by operating activities increased to $306,639,000 in 2005 from $275,617,000 in 2004, primarily due to additional NOI from our Established Community operations, as well as NOI from recently developed communities, partially offset by the loss of NOI from the 12 communities sold in 2005 and 2004, as discussed earlier in this report.

Investing Activities—Net cash used in investing activities of $19,761,000 in 2005 related to investments in assets through development, redevelopment and acquisition of apartment communities, including the acquisition of a partner interest in a real estate joint venture, substantially all of which is offset by proceeds from asset dispositions, including the proceeds from the sale of a technology investment. During 2005, we invested $459,376,000 in the purchase and development of real estate and capital expenditures:

- we began the development of 12 new communities. These communities, if developed as expected, will contain a total of 3,365 apartment homes, and the total capitalized cost, including land acquisition costs, is projected to be approximately $882,700,000. We completed the development of seven communities containing an aggregate of 1,971 apartment homes for a total capitalized cost, including land acquisition cost, of $408,200,000;
- we completed the redevelopment of three communities containing 1,094 apartment homes for a total capitalized cost of $196,700,000, of which $165,700,000 was incurred prior to redevelopment;
- we acquired the 75% equity interest of a third-party partner in a joint venture owning one community for a net purchase price of $57,415,000;
- we contributed $6,278,000 for a 15.2% equity interest in the Fund, which upon contribution owned four apartment communities containing a total of 879 apartment homes with an aggregate gross real estate value of $112,852,000. We also received net proceeds of $87,948,000 as reimbursement for acquiring and warehousing these communities. In December 2005, we contributed an additional $5,303,000 to the Fund, bringing our total equity investment in the Fund to approximately $11,600,000;
- we acquired 13 parcels of land in connection with Development Rights, for an aggregate purchase price of $115,849,000; and
- we had capital expenditures relating to current communities' real estate assets of $17,570,000 and non-real estate capital expenditures of $1,520,000.

Financing Activities—Net cash used in financing activities totaled $282,293,000 in 2005, consisting primarily of dividends paid, certain unsecured note repayments and mortgage note repayments, partially offset by the issuance of common stock for option exercises, the issuance of unsecured notes and mortgage notes payable including draws on construction loans and an increase in borrowings under our unsecured credit facility. See Note 3, "Notes Payable, Unsecured Notes and Credit Facility," and Note 4, "Stockholders' Equity," of our Consolidated Financial Statements, for additional information.

Variable Rate Unsecured Credit Facility We have a $500,000,000 revolving variable rate unsecured credit facility with JPMorgan Chase Bank and Wachovia Bank, N.A. serving as banks and syndication agents for a syndicate of commercial banks and Bank of America, serving as bank and administrative agent. Under the terms of the credit facility, we may elect to increase the facility by up to an additional $150,000,000, provided that one or more banks (from the syndicate or otherwise) voluntarily agree to provide the additional commitment. No member of the syndicate of banks can prohibit such increase; such an increase in the facility will only be effective to the extent banks (from the syndicate or otherwise) choose to commit to lend additional funds. We pay participating banks, in the aggregate, an annual facility fee of approximately $750,000. The unsecured credit facility bears interest at varying levels based on the London Interbank Offered Rate ("LIBOR"), rating levels achieved on our unsecured notes and on a maturity schedule selected by us. The current stated pricing is LIBOR plus 0.55% per annum (5.12% on January 31, 2006). The spread over LIBOR can vary from LIBOR plus 0.50% to LIBOR plus 1.15% based upon the rating of our long-term unsecured debt. In addition, a competitive bid option is available for borrowings of up to $250,000,000. This option allows banks that are part of the lender consortium to bid to provide us loans at a rate that is lower than the stated pricing provided by the unsecured credit facility. The competitive bid option may result in lower pricing if market conditions allow. We had no outstanding balance under this competitive bid option at January 31, 2006. We

are subject to (i) certain customary covenants under the unsecured credit facility, including, but not limited to, maintaining certain maximum leverage ratios, a minimum fixed charges coverage ratio and minimum unencumbered assets and equity levels, and (ii) prohibitions on paying dividends in amounts that exceed 95% of our FFO, except as may be required to maintain our REIT status. The credit facility matures in May 2008, assuming our exercise of a one-year renewal option. At January 31, 2006, $16,000,000 was outstanding, $39,504,000 was used to provide letters of credit and $444,496,000 was available for borrowing under the unsecured credit facility.

Future Financing and Capital Needs—Debt Maturities One of our principal long-term liquidity needs is the repayment of long-term debt at the time that such debt matures. For unsecured notes, we anticipate that no significant portion of the principal of these notes will be repaid prior to maturity. If we do not have funds on hand sufficient to repay our indebtedness as it becomes due, it will be necessary for us to refinance the debt. This refinancing may be accomplished by uncollateralized private or public debt offerings, additional debt financing that is collateralized by mortgages on individual communities or groups of communities, draws on our unsecured credit facility or by additional equity offerings. Although we believe we will have the capacity to meet our long-term liquidity needs, we cannot assure you that additional debt financing or debt or equity offerings will be available or, if available, that they will be on terms we consider satisfactory.

The following debt activity occurred during the year ended December 31, 2005:

- We repaid $150,000,000 in previously issued unsecured notes in January 2005, along with any unpaid interest, pursuant to their scheduled maturity. No prepayment penalty was incurred;
- We issued $100,000,000 in unsecured notes in March 2005 under our existing shelf registration statement at an annual effective interest rate of 4.999%. Interest on these notes is payable semi-annually on March 15 and September 15, and they mature in March 2013;
- In connection with the admission of outside investors into the Fund, we deconsolidated the assets and liabilities of four communities owned by the Fund, including $24,869,000 in fixed rate mortgage debt secured by two of the communities;
- We made a payment in the amount of $36,142,000 to the third-party lender of a joint venture entity that was unconsolidated at December 31, 2004 but was consolidated in March 2005 upon acquisition of the 75% equity interest of the third-party partner; and
- We assumed $4,566,000 in fixed rate debt in connection with the acquisition of a parcel of improved land.

We currently have an effective shelf registration statement on file with the Securities and Exchange Commission. The shelf registration statement originally provided for the issuance of $750,000,000 of debt and equity in one or more public offerings, however, only $370,984,000 remains available for issuance. We expect to increase our debt and equity capacity in early 2006. However, we cannot assure you that market conditions will permit us to issue debt or equity securities on cost-effective terms or that the registration statement will remain available and effective at all times.

Future Financing and Capital Needs—Portfolio and Other Activity As of December 31, 2005, we had 15 new communities under construction, for which a total estimated cost of $598,412,000 remained to be invested. In addition, we had two communities under reconstruction, for which a total estimated cost of $1,656,000 remained to be invested. Substantially all of the capital expenditures necessary to complete the communities currently under construction and reconstruction, as well as development costs related to pursuing Development Rights, will be funded from:

- the remaining capacity under our current $500,000,000 unsecured credit facility;
- the net proceeds from sales of existing communities;
- retained operating cash;
- the issuance of debt or equity securities; and/or
- private equity funding.

Before planned reconstruction activity, including reconstruction activity related to the Fund as discussed below, or the construction of a Development Right begins, we intend to arrange adequate financing to complete these undertakings, although we cannot assure you that we will be able to obtain such financing. In the event that financing cannot be obtained, we may have to abandon Development Rights, write-off associated pre-development costs that were capitalized and/or forego reconstruction activity. In such instances, we will not realize the increased revenues and earnings that we expected from such Development Rights or reconstruction activity and significant losses could be incurred.

We have invested in the Fund, a private, discretionary investment vehicle that will acquire and operate apartment communities in our markets. The Fund will serve, until March 16, 2008 or until 80% of its committed capital is invested, as the exclusive vehicle through which we will acquire apartment communities, subject to certain exceptions. These exceptions include significant individual asset and portfolio acquisitions, properties acquired in tax-deferred transactions and acquisitions that are inadvisable or inappropriate for the Fund, if any. The Fund will not restrict our development activities, and will terminate after a term of eight years, subject to two one-year extensions. The Fund has nine institutional investors, including us, with combined capital commitments of $330,000,000. A significant portion of the investments made in the Fund by its investors are being made through AvalonBay Value Added Fund, Inc., a Maryland corporation that will qualify as a REIT under the Internal Revenue Code (the "Fund REIT"). A wholly-owned subsidiary of the Company is the general partner of the Fund and has committed $50,000,000 to the Fund and the Fund REIT (of which approximately $11,600,000 has been invested as of January 31, 2006) representing a 15.2% combined general partner and limited partner equity interest. Under the Fund documents, the Fund has the ability to employ leverage through debt financings up to 65% on a portfolio basis, which, if achieved, would enable the Fund to invest up to $940,000,000.

From time to time we use joint ventures to hold or develop individual real estate assets. We generally employ joint ventures primarily to mitigate asset concentration or market risk and secondarily as a source of liquidity. We may also use joint ventures related to mixed-use land development opportunities where our partners bring development and operational expertise to the venture. Each joint venture or partnership agreement has been and will continue to be individually negotiated, and our ability to operate and/or dispose of a community in our sole discretion may be limited to varying degrees depending on the terms of the joint venture or partnership agreement. However, we cannot assure you that we will achieve our objectives through joint ventures.

In evaluating our allocation of capital within our markets, we sell assets that do not meet our long-term investment criteria or when capital and real estate markets allow us to realize a portion of the value created over the past business cycle and redeploy the proceeds from those sales to develop and redevelop communities. In response to real estate and capital markets conditions, including strong institutional demand for real estate assets in our markets and demand from condominium converters, we sold seven communities with net proceeds in the aggregate of $344,185,000 in 2005, and expect to sell communities at an aggregate sales price of $225,000,000 to $300,000,000 in 2006. We cannot assure you that assets can continue to be sold on terms that we consider satisfactory or that market conditions will continue to make the sale of assets an appealing strategy. Because the proceeds from the sale of communities may not be immediately redeployed into revenue generating assets, the immediate effect of a sale of a community for a gain is to increase net income, but reduce future total revenues, total expenses, NOI and FFO. As of January 31, 2006, we have one community classified as held for sale under GAAP. We are actively pursuing the disposition of this community and expect to close on this disposition within the next twelve months. However, we cannot assure you that this community will be sold as planned.

Off Balance Sheet Arrangements

We own interests in unconsolidated real estate entities, with ownership interests up to 50%. Four of these unconsolidated real estate entities, Avalon Terrace, LLC, CVP I, LLC, Mission Bay Venture Partners, LLC and the Fund, have debt outstanding as of December 31, 2005 as follows. Additional discussion of these entities can be found in Note 6, "Investments in Unconsolidated Entities," of our Consolidated Financial Statements located elsewhere in this report.

- Avalon Terrace, LLC has $37,200,000 of fixed rate debt which matures in November 2010 and is payable by the unconsolidated real estate entity with operating cash flow from the underlying real estate. We have not guaranteed the debt on Avalon Terrace, LLC, nor do we have any obligation to fund this debt should the unconsolidated real estate entity be unable to do so.
- CVP I, LLC has outstanding bonds in the amount of $117,000,000 which mature in February 2009, assuming exercise of two one-year renewal options, and are payable by the unconsolidated real estate entity. In connection with the general contractor services that we provided to CVP I, LLC, the entity that owns and developed Avalon Chrystie Place I, we have provided a construction completion guarantee to the lender in order to fulfill their standard financing requirements related to the bond financing. Our obligations under this guarantee will terminate once all of the lender's standard completion requirements have been satisfied. We currently expect this to occur in early 2006.

- Mission Bay Venture Partners, LLC has a construction loan in the amount of $94,400,000 (of which $28,354,000 is outstanding as of December 31, 2005), which matures in September 2010, assuming exercise of two one-year renewal options, and is payable by the unconsolidated real estate entity. In connection with the general contractor services that we provide to Mission Bay Venture Partners, LLC, the entity that owns and is developing Avalon Mission Bay North II, we have provided a construction completion guarantee to the lender in order to fulfill their standard financing requirements related to the construction financing. Our obligations under this guarantee will terminate following construction completion once all of the lender's standard completion requirements have been satisfied. We currently expect this to occur in 2007.
- The Fund has six mortgage loans with amounts outstanding of $16,765,000, $16,575,000, $31,500,000, $23,806,000, $7,960,000 and $16,500,000, which mature in October 2011, April 2012, July 2012, August 2013, February 2028 (but can be prepaid after February 2008 without penalty) and October 2012, respectively. These mortgage loans are secured by the underlying real estate. In addition, the Fund has a credit facility with $37,100,000 outstanding as of December 31, 2005, which matures in January 2008. The mortgage loans and the credit facility are payable by the Fund with operating cash flow from the underlying real estate, and the credit facility is secured by capital commitments. We have not guaranteed the debt of the Fund, nor do we have any obligation to fund this debt should the Fund be unable to do so.

In addition, as part of the formation of the Fund, we have provided to one of the limited partners a guarantee. The guarantee provides that, if, upon final liquidation of the Fund, the total amount of all distributions to that partner during the life of the Fund (whether from operating cash flow or property sales) does not equal the total capital contributions made by that partner, then we will pay the partner an amount equal to the shortfall, but in no event more than 10% of the total capital contributions made by the partner (maximum of approximately $1,700,000 as of December 31, 2005). We have not recorded a liability related to this guarantee as of December 31, 2005, as the fair value of the real estate assets owned by the Fund is considered adequate to cover such payment under a liquidation scenario.

There are no other lines of credit, side agreements, financial guarantees or any other derivative financial instruments related to or between us and our unconsolidated real estate entities. In evaluating our capital structure and overall leverage, management takes into consideration our proportionate share of this unconsolidated debt.

Contractual Obligations

We currently have contractual obligations consisting primarily of long-term debt obligations and lease obligations for certain land parcels and regional and administrative office space. Scheduled contractual obligations required for the next five years and thereafter are as follows as of December 31, 2005:

	Payments due by period				
(dollars in thousands)	Total	Less than 1 Year	1–3 Years	3–5 Years	More than 5 Years
Long-Term Debt Obligations[1]	$2,367,382	$223,787	$510,799	$463,185	$1,169,611
Operating Lease Obligations[2]	1,185,093	3,454	6,915	6,044	1,168,680
Total	$3,552,475	$227,241	$517,714	$469,229	$2,338,291

(1) Includes $66,800 outstanding under our variable rate unsecured credit facility as of December 31, 2005. The table of contractual obligations assumes repayment of this amount in 2006—See "Liquidity and Capital Resources." Amounts exclude interest payable as of December 31, 2005.

(2) Includes land leases expiring between July 2029 and March 2142. Amounts do not include any adjustment for purchase options available under the land leases.

Inflation and Deflation

Substantially all of our apartment leases are for a term of one year or less. In an inflationary environment, this may allow us to realize increased rents upon renewal of existing leases or the beginning of new leases. Short-term leases generally minimize our risk from the adverse effects of inflation, although these leases generally permit residents to leave at the end of the lease term and therefore expose us to the effect of a decline in market rents. In a deflationary rent environment, we may be exposed to declining rents more quickly under these shorter term leases.

Forward-Looking Statements

This Annual Report contains "forward-looking statements" as that term is defined under the Private Securities Litigation Reform Act of 1995. You can identify forward-looking statements by our use of the words "believe," "expect," "anticipate," "intend," "estimate," "assume," "project," "plan," "may," "shall," "will" and other similar expressions in this Annual Report, that predict or indicate future events and trends and that do not report historical matters. These statements include, among other things, statements regarding our intent, belief or expectations with respect to:

- our potential development, redevelopment, acquisition or disposition of communities;
- the timing and cost of completion of apartment communities under construction, reconstruction, development or redevelopment;
- the timing of lease-up, occupancy and stabilization of apartment communities;
- the pursuit of land on which we are considering future development;
- the anticipated operating performance of our communities;
- cost, yield and earnings estimates;
- our declaration or payment of distributions;
- our joint venture and discretionary fund activities;
- our policies regarding investments, indebtedness, acquisitions, dispositions, financings and other matters;
- our qualification as a REIT under the Internal Revenue Code;
- the real estate markets in Northern and Southern California and markets in selected states in the Mid-Atlantic, Northeast, Midwest and Pacific Northwest regions of the United States and in general;
- the availability of debt and equity financing;
- interest rates;
- general economic conditions; and
- trends affecting our financial condition or results of operations.

We cannot assure the future results or outcome of the matters described in these statements; rather, these statements merely reflect our current expectations of the approximate outcomes of the matters discussed. You should not rely on forward-looking statements because they involve known and unknown risks, uncertainties and other factors, some of which are beyond our control. These risks, uncertainties and other factors may cause our actual results, performance or achievements to differ materially from the anticipated future results, performance or achievements expressed or implied by these forward-looking statements. These risks, uncertainties and other factors are discussed in our Annual Report on Form 10-K for 2005 in the section titled "Risk Factors" and in other reports and documents filed with the Securities and Exchange Commission.

In addition, these forward-looking statements represent our estimates and assumptions only as of the date of this report. We do not undertake to update these forward-looking statements, and therefore they may not represent our estimates and assumptions after the date of this report.

Quantitative and Qualitative Disclosures About Market Risk

We are exposed to certain financial market risks, the most predominant being fluctuations in interest rates. We monitor interest rate fluctuations as an integral part of our overall risk management program, which recognizes the unpredictability of financial markets and seeks to reduce the potentially adverse effect on our results of operations. The effect of interest rate fluctuations historically has been small relative to other factors affecting operating results, such as rental rates and occupancy. The specific market risks and the potential impact on our operating results are described below.

Our operating results are affected by changes in interest rates as a result of borrowings under our variable rate unsecured credit facility as well as outstanding bonds with variable interest rates. We had $241,712,000 and $217,881,000 in variable rate debt outstanding (excluding variable rate debt effectively fixed through swap agreements) as of December 31, 2005 and 2004, respectively. If interest rates on the variable rate debt had been 100 basis points higher throughout 2005 and 2004, our annual interest costs would have increased by approximately $3,990,000 and $3,682,000, respectively, based on balances outstanding during the applicable years.

We currently use interest rate protection agreements (consisting of interest rate swap and cap agreements) to reduce the impact of interest rate fluctuations on certain variable rate indebtedness. Under swap agreements:

- we agree to pay to a counterparty the interest that would have been incurred on a fixed principal amount at a fixed interest rate (generally, the interest rate on a particular treasury bond on the date the agreement is entered into, plus a fixed increment); and
- the counterparty agrees to pay to us the interest that would have been incurred on the same principal amount at an assumed floating interest rate tied to a particular market index.

As of December 31, 2005, the effect of swap agreements is to fix the interest rate on approximately $67,400,000 of our variable rate, tax-exempt debt. The interest rate protection provided by certain swap agreements on the consolidated variable rate, tax-exempt debt was not electively entered into by us but, rather, was a requirement of either the bond issuer or the credit enhancement provider related to certain of our tax-exempt bond financings. Because the counterparties providing the swap agreements are major financial institutions which have an A+ or better credit rating by the Standard & Poor's Ratings Group and the interest rates fixed by the swap agreements are significantly higher than current market rates for such agreements, we do not believe there is exposure at this time to a default by a counterparty provider. Had these swap agreements not been in place during 2005 and 2004, our annual interest costs would have been approximately $1,878,000 and $2,769,000 lower, respectively, based on balances outstanding and reported interest rates during the applicable years. Additionally, if the variable interest rates on this debt had been 100 basis points higher throughout 2005 and 2004 and these swap agreements had not been in place, our annual interest costs would have been approximately $1,200,000 and $2,073,000 lower, respectively.

In addition, changes in interest rates affect the fair value of our fixed rate debt, which impacts the fair value of our aggregate indebtedness. Debt securities and notes payable (excluding our variable rate unsecured credit facility) with an aggregate carrying value of $2,300,582,000 at December 31, 2005 had an estimated aggregate fair value of $2,426,250,000 at December 31, 2005. Fixed rate debt (excluding our variable rate debt effectively fixed through swap agreements) represented $1,981,670,000 of the carrying value and $2,107,342,000 of the fair value at December 31, 2005. If interest rates had been 100 basis points higher as of December 31, 2005, the fair value of this fixed rate debt would have decreased by $88,418,000.

(Dollars in thousands, except per share data)	12-31-05	12-31-04
Assets		
Real estate:		
Land	$ 874,199	$ 863,867
Buildings and improvements	4,288,168	4,080,462
Furniture, fixtures and equipment	133,192	127,520
	5,295,559	5,071,849
Less accumulated depreciation	(938,297)	(769,459)
Net operating real estate	4,357,262	4,302,390
Construction in progress, including land	317,823	173,290
Land held for development	188,414	156,350
Operating real estate assets held for sale, net	82,289	245,795
Total real estate, net	4,945,788	4,877,825
Cash and cash equivalents	6,106	1,521
Cash in escrow	48,266	22,138
Resident security deposits	26,290	23,478
Investments in unconsolidated real estate entities	41,942	41,379
Deferred financing costs, net	17,976	21,859
Deferred development costs	31,467	37,007
Prepaid expenses and other assets	47,225	56,042
Total assets	$5,165,060	$5,081,249
Liabilities and Stockholders' Equity		
Unsecured notes	$1,809,182	$1,859,448
Variable rate unsecured credit facility	66,800	102,000
Mortgage notes payable	490,582	489,906
Dividends payable	54,476	52,982
Payables for construction	28,203	23,005
Accrued expenses and other liabilities	82,564	73,223
Accrued interest payable	34,649	37,254
Resident security deposits	35,640	33,208
Liabilities related to real estate assets held for sale	1,837	3,407
Total liabilities	2,603,933	2,674,433
Minority interest of unitholders in consolidated partnerships	19,464	21,525
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.01 par value; $25 liquidation preference; 50,000,000 shares authorized at both December 31, 2005 and 2004; 4,000,000 shares issued and outstanding at both December 31, 2005 and 2004	40	40
Common stock, $0.01 par value; 140,000,000 shares authorized at both December 31, 2005 and 2004; 73,663,048 and 72,582,076 shares issued and outstanding at December 31, 2005 and 2004, respectively	737	726
Additional paid-in capital	2,442,528	2,389,511
Deferred compensation	(12,960)	(8,659)
Accumulated earnings less dividends	115,788	10,769
Accumulated other comprehensive loss	(4,470)	(7,096)
Total stockholders' equity	2,541,663	2,385,291
Total liabilities and stockholders' equity	$5,165,060	$5,081,249

See accompanying notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF OPERATIONS AND OTHER COMPREHENSIVE INCOME

(Dollars in thousands, except per share data)	For the year ended 12-31-05	12-31-04	12-31-03
Revenue:			
Rental and other income	$666,376	$613,240	$556,582
Management, development and other fees	4,304	604	931
Total revenue	670,680	613,844	557,513
Expenses:			
Operating expenses, excluding property taxes	191,558	181,351	164,253
Property taxes	65,487	59,458	53,257
Interest expense, net	127,099	131,103	130,178
Depreciation expense	158,822	151,991	138,725
General and administrative expense	25,761	18,074	14,830
Total expenses	568,727	541,977	501,243
Equity in income of unconsolidated entities	7,198	1,100	25,535
Venture partner interest in profit-sharing	—	(1,178)	(1,688)
Minority interest in consolidated partnerships	(1,481)	(150)	(950)
Income from continuing operations before cumulative effect of change in accounting principle	107,670	71,639	79,167
Discontinued operations:			
Income from discontinued operations	14,942	21,134	31,368
Gain on sale of real estate assets	199,766	122,425	160,990
Total discontinued operations	214,708	143,559	192,358
Income before cumulative effect of change in accounting principle	322,378	215,198	271,525
Cumulative effect of change in accounting principle	—	4,547	—
Net income	322,378	219,745	271,525
Dividends attributable to preferred stock	(8,700)	(8,700)	(10,744)
Net income available to common stockholders	$313,678	$211,045	$260,781
Other comprehensive income:			
Unrealized gain on cash flow hedges	2,626	1,116	4,428
Comprehensive income	$316,304	$212,161	$265,209
Earnings per common share—basic:			
Income from continuing operations (net of dividends attributable to preferred stock)	$ 1.36	$ 0.94	$ 1.00
Discontinued operations	2.94	2.01	2.80
Net income available to common stockholders	$ 4.30	$ 2.95	$ 3.80
Earnings per common share—diluted:			
Income from continuing operations (net of dividends attributable to preferred stock)	$ 1.34	$ 0.94	$ 0.99
Discontinued operations	2.87	1.98	2.74
Net income available to common stockholders	$ 4.21	$ 2.92	$ 3.73

See accompanying notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(Dollars in thousands)	Shares issued								
	Preferred stock	Common stock	Preferred stock	Common stock	Additional paid-in capital	Deferred compen-sation	Accumulated earnings less dividends	Accumulated other com-prehensive loss	Stock-holders' equity
Balance at December 31, 2002	7,267,700	68,202,926	$73	$682	$2,273,668	$ (7,855)	$ (59,388)	$(12,640)	$2,194,540
Net income	—	—	—	—	—	—	271,525	—	271,525
Unrealized gain on cash flow hedges	—	—	—	—	—	—	—	4,428	4,428
Dividends declared to common and preferred stockholders	—	—	—	—	—	—	(202,694)	—	(202,694)
Issuance of common stock, net of withholdings	—	3,833,600	—	38	162,674	(1,383)	(114)	—	161,215
Issuance of stock options	—	—	—	—	754	(754)	—	—	—
Repurchase of common stock, including repurchase costs	—	(1,099,000)	—	(11)	(32,841)	—	(7,025)	—	(39,877)
Issuance of preferred stock, net of issuance costs	3,336,611	—	33	—	81,704	—	—	—	81,737
Redemption of preferred stock	(6,604,311)	—	(66)	—	(163,378)	—	(280)	—	(163,724)
Amortization of deferred compensation	—	—	—	—	—	4,184	—	—	4,184
Balance at December 31, 2003	4,000,000	70,937,526	40	709	2,322,581	(5,808)	2,024	(8,212)	2,311,334
Net income	—	—	—	—	—	—	219,745	—	219,745
Unrealized gain on cash flow hedges	—	—	—	—	—	—	—	1,116	1,116
Dividends declared to common and preferred stockholders	—	—	—	—	—	—	(210,338)	—	(210,338)
Issuance of common stock, net of withholdings	—	1,644,550	—	17	64,849	(5,702)	(662)	—	58,502
Issuance of stock options	—	—	—	—	2,081	(2,081)	—	—	—
Amortization of deferred compensation	—	—	—	—	—	4,932	—	—	4,932
Balance at December 31, 2004	4,000,000	72,582,076	40	726	2,389,511	(8,659)	10,769	(7,096)	2,385,291
Net income	—	—	—	—	—	—	322,378	—	322,378
Unrealized gain on cash flow hedges	—	—	—	—	—	—	—	2,626	2,626
Dividends declared to common and preferred stockholders	—	—	—	—	—	—	(216,982)	—	(216,982)
Issuance of common stock, net of withholdings	—	1,080,972	—	11	48,496	(8,118)	(377)	—	40,012
Issuance of stock options	—	—	—	—	4,521	(4,521)	—	—	—
Amortization of deferred compensation	—	—	—	—	—	8,338	—	—	8,338
Balance at December 31, 2005	**4,000,000**	**73,663,048**	**$40**	**$737**	**$2,442,528**	**$(12,960)**	**$115,788**	**$ (4,470)**	**$2,541,663**

See accompanying notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the year ended		
(Dollars in thousands)	12-31-05	12-31-04	12-31-03
Cash flows from operating activities:			
Net income	$322,378	$219,745	$271,525
Adjustments to reconcile net income to cash provided by operating activities:			
Depreciation expense	158,822	151,991	138,725
Depreciation expense from discontinued operations	3,241	10,676	15,071
Amortization of deferred financing costs and debt premium/discount	4,022	3,962	3,850
Amortization of deferred compensation	8,338	4,932	4,184
Income allocated to minority interest in consolidated partnerships including discontinued operations	1,481	187	1,388
Income allocated to venture partner interest in profit-sharing	—	1,178	1,688
Gain on sale of real estate assets	(199,766)	(122,425)	(160,990)
Gain on sale of technology investment	(6,252)	—	—
Gain on sale of joint venture community	—	—	(23,448)
Cumulative effect of change in accounting principle	—	(4,547)	—
Increase in cash in operating escrows	(4,344)	(1,451)	(557)
Decrease (increase) in resident security deposits, prepaid expenses and other assets	8,938	(10,589)	(7,025)
Increase (decrease) in accrued expenses, other liabilities and accrued interest payable	9,781	21,958	(4,734)
Net cash provided by operating activities	306,639	275,617	239,677
Cash flows from investing activities:			
Development/redevelopment of real estate assets including land acquisitions and deferred development costs	(382,871)	(355,938)	(357,520)
Acquisition of real estate assets, including partner equity interest	(57,415)	(128,238)	—
Capital expenditures—existing real estate assets	(17,570)	(12,984)	(11,593)
Capital expenditures—non-real estate assets	(1,520)	(860)	(274)
Proceeds from sale of communities and technology investment, including reimbursement for Fund communities, net of selling costs	469,737	219,649	403,118
Increase (decrease) in payables for construction	5,198	(3,962)	(331)
Decrease (increase) in cash in construction escrows	(21,784)	201	(1,040)
Repayment of participating mortgage note, including interest and prepayment premium	—	34,846	—
Decrease (increase) in investments in unconsolidated real estate entities	(13,536)	(4,397)	1,575
Net cash provided by (used in) investing activities	(19,761)	(251,683)	33,935
Cash flows from financing activities:			
Issuance of common stock	36,611	54,031	146,934
Repurchase of common stock	—	—	(39,877)
Issuance of preferred stock, net of related costs	—	—	81,737
Redemption of preferred stock and related costs	—	—	(163,724)
Dividends paid	(215,391)	(209,095)	(202,416)
Net borrowings (repayments) under unsecured credit facility	(35,200)	50,900	22,130
Issuance of mortgage notes payable and draws on construction loans	26,269	105,843	38,829
Repayments of mortgage notes payable	(41,932)	(40,270)	(4,582)
Issuance (repayment) of unsecured notes	(50,000)	25,000	(150,000)
Payment of deferred financing costs	(1,292)	(9,318)	(1,477)
Redemption of units for cash by minority partners	(50)	(1,691)	(600)
Distributions to DownREIT partnership unitholders	(1,194)	(1,425)	(2,152)
Distributions to joint venture and profit-sharing partners	(114)	(3,446)	(4,267)
Net cash used in financing activities	(282,293)	(29,471)	(279,465)
Net increase (decrease) in cash and cash equivalents	4,585	(5,537)	(5,853)
Cash and cash equivalents, beginning of year	1,521	7,058	12,911
Cash and cash equivalents, end of year	$ 6,106	$ 1,521	$ 7,058
Cash paid during year for interest, net of amount capitalized	$121,526	$124,895	$131,266

See accompanying notes to Consolidated Financial Statements.

Supplemental disclosures of non-cash investing and financing activities (dollars in thousands):

During the year ended December 31, 2005:

- As described in Note 4, "Stockholders' Equity," 165,790 shares of common stock were issued in connection with stock grants, 1,295 shares were issued through the Company's dividend reinvestment plan, 8,971 shares were issued to a member of the Board of Directors in fulfillment of a deferred stock award, 50,916 shares were withheld to satisfy employees' tax withholding and other liabilities and 9,965 shares were forfeited, for a net value of $9,317. In addition, the Company granted 696,484 options for common stock, net of forfeitures, at a value of $4,521.
- 49,263 units of limited partnership, valued at $2,202, were presented for redemption to the DownREIT partnerships that issued such units and were acquired by the Company in exchange for an equal number of shares of the Company's common stock.
- The Company deconsolidated mortgage notes payable in the aggregate amount of $24,869 upon admittance of outside investors into the Fund (as defined in Note 6, "Investments in Unconsolidated Entities").
- The Company assumed fixed rate debt of $4,566 as part of the acquisition of an improved land parcel.
- The Company recorded a decrease to other liabilities and a corresponding gain to other comprehensive income of $2,626 to adjust the Company's Hedged Derivatives (as defined in Note 5, "Derivative Instruments and Hedging Activities") to their fair value.
- Common and preferred dividends declared but not paid totaled $54,476.

During the year ended December 31, 2004:

- 147,517 shares of common stock were issued in connection with stock grants, 78,509 shares were issued in connection with non-cash stock option exercises, 1,545 shares were issued through the Company's dividend reinvestment plan, 75,515 shares were withheld to satisfy employees' tax withholding and other liabilities and 3,012 shares were forfeited, for a net value of $6,138. In addition, the Company granted 465,232 options for common stock, net of forfeitures, at a value of $2,081.
- 104,160 units of limited partnership, valued at $4,035, were presented for redemption to the DownREIT partnerships that issued such units and were acquired by the Company in exchange for an equal number of shares of the Company's common stock.
- The Company sold two communities with mortgage notes payable of $28,335 in the aggregate, that were assumed by the respective buyers as part of the total sales price.
- The Company assumed fixed rate debt of $8,155 in connection with the acquisition of a community and $20,141 in connection with the acquisition of three improved land parcels.
- The Company recorded a decrease to other liabilities and a corresponding gain to other comprehensive income of $1,116 to adjust the Company's Hedged Derivatives to their fair value.
- Common and preferred dividends declared but not paid totaled $52,982.

During the year ended December 31, 2003:

- 114,895 shares of common stock were issued in connection with stock grants, 37,124 shares were withheld to satisfy employees' tax withholding and other liabilities and 12,102 shares were forfeited, for a net value of $2,419. In addition, the Company granted 268,101 options for common stock, net of forfeitures, at a value of $754.
- 328,731 units of limited partnership, valued at $13,245, were presented for redemption to the DownREIT partnerships that issued such units and were acquired by the Company in exchange for an equal number of shares of the Company's common stock.
- The Company sold two communities that were subject to mortgage notes payable of $39,665 in the aggregate, that were assumed by the buyers as part of the total sales price. $260 of deferred stock units were converted into 6,989 shares of common stock.
- The Company recorded a decrease to other liabilities and a corresponding gain to other comprehensive income of $4,428 to adjust the Company's Hedged Derivatives to their fair value.
- Common and preferred dividends declared but not paid totaled $51,831.

1. Organization and Significant Accounting Policies

Organization AvalonBay Communities, Inc. (the "Company," which term, unless the context otherwise requires, refers to AvalonBay Communities, Inc. together with its subsidiaries) is a Maryland corporation that has elected to be taxed as a real estate investment trust ("REIT") under the Internal Revenue Code of 1986, as amended. The Company focuses on the development, ownership and operation of apartment communities in high barrier-to-entry markets of the United States. These markets are located in the Northeast, Mid-Atlantic, Midwest, Pacific Northwest, and Northern and Southern California regions of the country.

At December 31, 2005, the Company owned or held a direct or indirect ownership interest in 143 operating apartment communities containing 41,412 apartment homes in ten states and the District of Columbia, of which two communities containing 506 apartment homes were under reconstruction. In addition, the Company owned or held a direct or indirect ownership interest in 15 communities under construction that are expected to contain an aggregate of 4,062 apartment homes when completed. The Company also owned or held a direct or indirect ownership interest in rights to develop an additional 47 communities that, if developed in the manner expected, will contain an estimated 12,495 apartment homes.

Principles of Consolidation The Company is the surviving corporation from the merger (the "Merger") of Bay Apartment Communities, Inc. ("Bay") and Avalon Properties, Inc. ("Avalon") on June 4, 1998, in which Avalon shareholders received 0.7683 of a share of common stock of the Company for each share owned of Avalon common stock. The Merger was accounted for under the purchase method of accounting, with the historical financial statements for Avalon presented prior to the Merger. At that time, Avalon ceased to legally exist, and Bay as the surviving legal entity adopted the historical financial statements of Avalon. Consequently, Bay's assets were recorded in the historical financial statements of Avalon at an amount equal to Bay's debt outstanding at that time plus the value of capital stock retained by the Bay stockholders, which approximates fair value. In connection with the Merger, the Company changed its name from Bay Apartment Communities, Inc. to AvalonBay Communities, Inc.

The Company assesses consolidation of variable interest entities under the guidance of FASB Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51," as revised in December 2003. The Company accounts for joint venture partnerships and subsidiary partnerships structured as DownREITs that are not variable interest entities in accordance with Statement of Position ("SOP") 78-9, "Accounting for Investments in Real Estate Ventures." Under SOP 78-9, the Company consolidates joint venture and DownREIT partnerships when the Company controls the major operating and financial policies of the partnership through majority ownership or in its capacity as general partner. The accompanying Consolidated Financial Statements include the accounts of the Company and its wholly-owned partnerships, certain joint venture partnerships, subsidiary partnerships structured as DownREITs and any variable interest entities consolidated under FIN 46. All significant intercompany balances and transactions have been eliminated in consolidation.

In each of the partnerships structured as DownREITs, either the Company or one of the Company's wholly-owned subsidiaries is the general partner, and there are one or more limited partners whose interest in the partnership is represented by units of limited partnership interest. For each DownREIT partnership, limited partners are entitled to receive an initial distribution before any distribution is made to the general partner. Although the partnership agreements for each of the DownREITs are different, generally the distributions per unit paid to the holders of units of limited partnership interests have approximated the Company's current common stock dividend per share. Each DownREIT partnership has been structured so that it is unlikely the limited partners will be entitled to a distribution greater than the initial distribution provided for in the partnership agreement. The holders of units of limited partnership interest have the right to present all or some of their units for redemption for a cash amount as determined by the applicable partnership agreement and based on the fair value of the Company's common stock. In lieu of a cash redemption, the Company may elect to acquire such units for an equal number of shares of the Company's common stock.

The Company accounts for investments in unconsolidated entities that are not variable interest entities in accordance with SOP 78-9 and Accounting Principles Board ("APB") Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock." The Company uses the equity method to account for these investments when it owns greater than 20% of the equity value or has significant influence over that entity. Investments in which the Company owns 20% or less of the equity value and does not have significant influence are accounted for using the cost method. If there is an event or change in circumstance that indicates a loss in the value of an investment, the Company's policy is to record the loss and reduce the value of the investment to its fair value. A loss in value would be indicated if the Company could not recover the carrying value of the investment or if the investee could not sustain an earnings capacity that would justify the carrying amount of the

investment. During the year ended December 31, 2004, the Company recorded an impairment loss of $1,002 related to a technology investment, which is included in operating expenses, excluding property taxes on the accompanying Consolidated Statements of Operations and Other Comprehensive Income. The Company did not recognize an impairment loss on any of its investments in unconsolidated entities during the years ended December 31, 2005 or 2003.

Revenue Recognition Rental income related to leases is recognized on an accrual basis when due from residents in accordance with SEC Staff Accounting Bulletin No. 104, "Revenue Recognition" and Statement of Financial Accounting Standards ("SFAS") No. 13, "Accounting for Leases." In accordance with the Company's standard lease terms, rental payments are generally due on a monthly basis. Any cash concessions given at the inception of the lease are amortized over the approximate life of the lease, which is generally one year.

Real Estate Significant expenditures which improve or extend the life of an asset are capitalized. The operating real estate assets are stated at cost and consist of land, buildings and improvements, furniture, fixtures and equipment, and other costs incurred during their development, redevelopment and acquisition. Expenditures for maintenance and repairs are charged to operations as incurred.

The Company's policy with respect to capital expenditures is generally to capitalize only non-recurring expenditures. Improvements and upgrades are capitalized only if the item exceeds $15, extends the useful life of the asset and is not related to making an apartment home ready for the next resident. Purchases of personal property, such as computers and furniture, are capitalized only if the item is a new addition and exceeds $2.5. The Company generally expenses purchases of personal property made for replacement purposes.

The capitalization of costs during the development of assets (including interest and related loan fees, property taxes and other direct and indirect costs) begins when development efforts commence and ends when the asset, or a portion of an asset, is delivered and is ready for its intended use, which is generally indicated by the issuance of a certificate of occupancy. Cost capitalization during redevelopment of apartment homes (including interest and related loan fees, property taxes and other direct and indirect costs) begins when an apartment home is taken out-of-service for redevelopment and ends when the apartment home redevelopment is completed and the apartment home is available for a new resident. Rental income and operating costs incurred during the initial lease-up or post-redevelopment lease-up period are fully recognized as they accrue.

In accordance with SFAS No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects," the Company capitalizes pre-development costs incurred in pursuit of new development opportunities for which the Company currently believes future development is probable ("Development Rights"). Future development of these Development Rights is dependent upon various factors, including zoning and regulatory approval, rental market conditions, construction costs and availability of capital. Pre-development costs incurred in the pursuit of Development Rights for which future development is not yet considered probable are expensed as incurred. In addition, if the status of a Development Right changes, deeming future development no longer probable, any capitalized pre-development costs are written-off with a charge to expense. The Company expensed costs related to abandoned pursuits, which includes the abandonment or impairment of Development Rights, acquisition pursuits, disposition pursuits and technology investments, in the amounts of $816, $1,726 and $1,180 for the years ended December 31, 2005, 2004 and 2003, respectively. These costs are included in operating expenses, excluding property taxes on the accompanying Consolidated Statements of Operations and Other Comprehensive Income.

The Company owns land improved with office buildings and industrial space occupied by unrelated third-parties in connection with five Development Rights. The Company intends to manage the current improvements until such time as all tenant obligations have been satisfied or eliminated through negotiation, and construction of new apartment communities is ready to begin. As provided under the guidance of SFAS No. 67, the revenue from incidental operations received from the current improvements in excess of any incremental costs are being recorded as a reduction of total capitalized costs of the Development Right and not as part of net income.

In connection with the acquisition of an operating community, the Company performs a valuation and allocation to each asset and liability acquired in such transaction, based on their estimated fair values at the date of acquisition in accordance with SFAS No. 141, "Business Combinations." The purchase price allocations to tangible assets, such as land, buildings and improvements, and furniture, fixtures and equipment, are reflected in real estate assets and depreciated over their estimated useful lives. Any purchase price allocation to intangible assets, such as in-place leases, is included in prepaid expenses and other assets and amortized over the average remaining lease term of the acquired leases. The fair value of acquired in-place leases is determined based on the estimated cost to replace such leases, including foregone rents during an assumed re-lease period, as well as the impact on projected cash flow of acquired leases with leased rents above or below current market rents.

Depreciation is calculated on buildings and improvements using the straight-line method over their estimated useful lives, which range from seven to thirty years. Furniture, fixtures and equipment are generally depreciated using the straight-line method over their estimated useful lives, which range from three years (primarily computer-related equipment) to seven years.

If there is an event or change in circumstance that indicates an impairment in the value of an operating community, the Company's policy is to assess any impairment in value by making a comparison of the current and projected operating cash flow of the community over its remaining useful life, on an undiscounted basis, to the carrying amount of the community. If the carrying amount is in excess of the estimated projected operating cash flow of the community, the Company would recognize an impairment loss equivalent to an amount required to adjust the carrying amount to its estimated fair market value. The Company has not recognized an impairment loss on any of its operating communities during the years ended December 31, 2005, 2004 or 2003.

Income Taxes The Company elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended, for the year ended December 31, 1994 and has not revoked such election. A corporate REIT is a legal entity which holds real estate interests and must meet a number of organizational and operational requirements, including a requirement that it currently distribute at least 90% of its adjusted taxable income to stockholders. As a REIT, the Company generally will not be subject to corporate level federal income tax on taxable income it distributes currently to its stockholders. Management believes that all such conditions for the avoidance of income taxes have been met for the periods presented. Accordingly, no provision for federal and state income taxes has been made. If the Company fails to qualify as a REIT in any taxable year, it will be subject to federal income taxes at regular corporate rates (including any applicable alternative minimum tax) and may not be able to qualify as a REIT for four subsequent taxable years. Even if the Company qualifies for taxation as a REIT, the Company may be subject to certain state and local taxes on its income and property, and to federal income and excise taxes on its undistributed taxable income. In addition, taxable income from non-REIT activities managed through taxable REIT subsidiaries is subject to federal, state and local income taxes.

The following reconciles net income available to common stockholders to taxable net income for the years ended December 31, 2005, 2004 and 2003:

	2005 Estimate	2004 Actual	2003 Actual
Net income available to common stockholders	$313,678	$211,045	$260,781
Dividends attributable to preferred stock, not deductible for tax	8,700	8,700	10,744
GAAP gain on sale of communities less than (in excess of) tax gain	(2,482)	8,305	(3,795)
Depreciation/Amortization timing differences on real estate	(3,861)	(3,793)	(5,574)
Tax compensation expense in excess of GAAP	(18,969)	(19,758)	(4,254)
Other adjustments	(2,021)	(9,835)	(9,190)
Taxable net income	$295,045	$194,664	$248,712

The following summarizes the tax components of the Company's common and preferred dividends declared for the years ended December 31, 2005, 2004 and 2003:

	2005	2004	2003
Ordinary income	9%	39%	11%
20% capital gain	—	—	15%
15% capital gain	77%	51%	56%
Unrecaptured §1250 gain	14%	10%	18%

Deferred Financing Costs Deferred financing costs include fees and costs incurred to obtain debt financing and are amortized on a straight-line basis, which approximates the effective interest method, over the shorter of the term of the loan or the related credit enhancement facility, if applicable. Unamortized financing costs are written-off when debt is retired before the maturity date. Accumulated amortization of deferred financing costs was $16,074 at December 31, 2005 and $12,966 at December 31, 2004.

Cash, Cash Equivalents and Cash in Escrow Cash and cash equivalents include all cash and liquid investments with an original maturity of three months or less from the date acquired. The majority of the Company's cash, cash equivalents and cash in escrows is held at major commercial banks.

Interest Rate Contracts The Company utilizes derivative financial instruments to manage interest rate risk and has designated these financial instruments as hedges under the guidance of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," and SFAS No. 138, "Accounting for Certain Instruments and Certain Hedging Activities, an Amendment of Statement No. 133." For fair value hedge transactions, changes in the fair value of the derivative instrument and changes in the fair value of the hedged item due to the risk being hedged are recognized in current period earnings. For cash flow hedge transactions, changes in the fair value of the derivative instrument are reported in other comprehensive income. For cash flow hedges where the changes in the fair value of the derivative exceed the change in fair value of the hedged item, the ineffective portion is recognized in current period earnings. Derivatives which are not part of a hedge relationship are recorded at fair value through earnings. As of December 31, 2005 and 2004, the Company had approximately $233,000 and $236,000, respectively, in variable rate debt subject to cash flow hedges. See Note 5, "Derivative Instruments and Hedging Activities."

Comprehensive Income Comprehensive Income, as reflected on the Consolidated Statements of Operations and Other Comprehensive Income, is defined as all changes in equity during each period except for those resulting from investments by or distributions to shareholders. Accumulated other comprehensive loss as reflected on the Consolidated Statements of Stockholders' Equity reflects the changes in the fair value of effective cash flow hedges.

Earnings per Common Share In accordance with the provisions of SFAS No. 128, "Earnings per Share," basic earnings per share is computed by dividing earnings available to common stockholders by the weighted average number of shares outstanding during the period. Other potentially dilutive common shares, and the related impact to earnings, are considered when calculating earnings per share on a diluted basis. The Company's earnings per common share are determined as follows:

	For the year ended		
	12-31-05	12-31-04	12-31-03
Basic and diluted shares outstanding			
Weighted average common shares—basic	72,952,492	71,564,202	68,559,657
Weighted average DownREIT units outstanding	474,440	573,529	893,279
Effect of dilutive securities	1,332,386	1,217,225	750,531
Weighted average common shares—diluted	74,759,318	73,354,956	70,203,467
Calculation of Earnings per Share—basic			
Net income available to common stockholders	$ 313,678	$ 211,045	$ 260,781
Weighted average common shares—basic	72,952,492	71,564,202	68,559,657
Earnings per common share—basic	$ 4.30	$ 2.95	$ 3.80
Calculation of Earnings per Share—diluted			
Net income available to common stockholders	$ 313,678	$ 211,045	$ 260,781
Add: Minority interest of DownREIT unitholders in consolidated partnerships, including discontinued operations	1,363	3,048	1,263
Adjusted net income available to common stockholders	$ 315,041	$ 214,093	$ 262,044
Weighted average common shares—diluted	74,759,318	73,354,956	70,203,467
Earnings per common share—diluted	$ 4.21	$ 2.92	$ 3.73

Certain options to purchase shares of common stock in the amounts of 4,500, 6,000 and 1,348,738 were outstanding during the years ended December 31, 2005, 2004 and 2003, respectively, but were not included in the computation of diluted earnings per share because the options' exercise prices were greater than the average market price of the common shares for the period and therefore, are anti-dilutive.

Stock-Based Compensation Effective January 1, 2003, the Company adopted the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123," prospectively to all employee awards

granted, modified, or settled on or after January 1, 2003. Awards under the Company's stock option plans vest over periods ranging from one to three years. Therefore, the cost related to stock-based employee compensation for employee stock options included in the determination of net income for the years ended December 31, 2005, 2004 and 2003 is less than that which would have been recognized if the fair value based method had been applied to all awards since the original effective date of SFAS No. 123. The Company will adopt the provisions of SFAS 123(R), "Share Based Payment," using the modified prospective transition method on January 1, 2006. The Company does not expect the adoption of SFAS 123(R) to have a material impact on its financial position or results of operations. However, the adoption of SFAS 123(R) will change the service period for, and timing of, the recognition of compensation cost related to retirement eligibility, which will generally result in accelerated expense recognition by the Company for its stock based compensation programs. The Company currently records compensation cost over the vesting period, regardless of eligibility for retirement (see Note 8, "Commitments and Contingencies," for a discussion of the Company's retirement plan). If the Company had recorded compensation cost based on retirement eligibility, the increase to compensation cost during the year ended December 31, 2005 would not have been material.

The following table illustrates the effect on net income available to common stockholders and earnings per share if the fair value based method had been applied to all outstanding and unvested awards in each period based on the fair market value as determined on the date of grant:

		For the year ended		
		12-31-05	12-31-04	12-31-03
Net income available to common stockholders, as reported		$313,678	$211,045	$260,781
Add:	Actual compensation expense recorded under fair value based method, net of related tax effects	2,133	867	246
Deduct:	Total compensation expense determined under fair value based method, net of related tax effects	(2,245)	(1,834)	(2,335)
	Pro forma net income available to common stockholders	$313,566	$210,078	$258,692
	Earnings per share:			
	Basic—as reported	$ 4.30	$ 2.95	$ 3.80
	Basic—pro forma	$ 4.30	$ 2.94	$ 3.77
	Diluted—as reported	$ 4.21	$ 2.92	$ 3.73
	Diluted—pro forma	$ 4.21	$ 2.91	$ 3.70

Variable Interest Entities under FIN 46 The Company adopted the final provisions of FIN 46 as of January 1, 2004, which resulted in the consolidation of one entity during 2004 from which the Company held a participating mortgage note. As a result, the Company recognized a cumulative effect of change in accounting principle in January 2004 in the amount of $4,547, which increased earnings per common share—diluted by $0.06. The Company did not hold an equity interest in this entity, and therefore 100% of the entity's net income or loss was recognized by the Company as minority interest in consolidated partnerships on the Consolidated Statements of Operations and Other Comprehensive Income. In October 2004, the Company received payment in full of the outstanding mortgage note. Upon note repayment, the Company did not continue to hold a variable interest in this entity and therefore the Company discontinued consolidating the entity under the provisions of FIN 46. Related interest income for the year ended December 31, 2003 of $3,168 is included in interest expense, net, in the accompanying Consolidated Statements of Operations and Other Comprehensive Income. Related interest income in the year ended December 31, 2004 has been eliminated in consolidation.

Discontinued Operations The Company follows SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" which requires that the assets and liabilities and the results of operations of any communities which have been sold, or otherwise qualify as held for sale, be presented as discontinued operations in the Company's Consolidated Financial Statements in both current and prior years presented. The community specific components of net income that are presented as discontinued operations include net operating income, depreciation expense, minority interest expense and interest expense. In addition, the net gain or loss (including any impairment loss) on the eventual disposal of communities held for sale will be presented as discontinued operations when recognized. A change in presentation for discontinued operations will not have any impact on the Company's financial condition or results of operations. Real estate assets held for sale are measured at the lower of the carrying amount or the fair value less the cost to sell, and are presented separately in the

accompanying Consolidated Balance Sheets. Subsequent to classification of a community as held for sale, no further depreciation is recorded.

Recently Issued Accounting Standards In June 2005, the Financial Accounting Standards Board ("FASB") ratified the consensus in EITF Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights," which provides guidance in determining whether a general partner controls a limited partnership. EITF Issue No. 04-5 states that the general partner in a limited partnership is presumed to control that limited partnership. That presumption may be overcome if the limited partners have either (i) the substantive ability, either by a single limited partner or through a simple majority vote, to dissolve the limited partnership or otherwise remove the general partner without cause or (ii) substantive participating rights. The Company adopted EITF Issue No. 04-5 on June 29, 2005 for all new limited partnerships formed or existing limited partnerships that were modified after June 29, 2005 and will adopt EITF Issue No. 04-5 on January 1, 2006 for other existing limited partnerships. The Company does not expect the final adoption of EITF Issue No. 04-5 to have a material impact on its financial position or results of operations.

In October 2005, the FASB issued Staff Position ("FSP") 13-1, "Accounting for Rental Costs Incurred During a Construction Period," which addresses the accounting for rental costs incurred during and after construction. FSP 13-1 is applicable for all reporting periods beginning after December 15, 2005 and concludes that rental costs incurred during and after a construction period are for the right to control the use of a leased asset during and after construction of a lessee asset. There is no distinction between the right to use that asset after the construction period. Therefore, rental costs associated with ground or building operating leases that are incurred during a construction period shall be recognized as rental expense. However, the capitalization of rental costs as allowed under the guidance of SFAS No. 67 is still appropriate and applicable. As such, the adoption of FSP 13-1 will not have a material impact on the Company's financial position or results of operations.

Use of Estimates The preparation of financial statements in conformity with generally accepted accounting principles ("GAAP") in the United States requires management to make certain estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from those estimates.

Reclassifications Certain reclassifications have been made to amounts in prior years' financial statements to conform with current year presentations.

2. Interest Capitalized

Capitalized interest associated with communities under development or redevelopment totaled $25,284, $20,566 and $24,709 for the years ended December 31, 2005, 2004 and 2003, respectively.

3. Notes Payable, Unsecured Notes and Credit Facility

The Company's mortgage notes payable, unsecured notes and variable rate unsecured credit facility as of December 31, 2005 and 2004 are summarized as follows:

	12-31-05	12-31-04
Fixed rate unsecured notes[1]	$1,809,182	$1,859,448
Fixed rate mortgage notes payable—conventional and tax-exempt	239,025	263,669
Variable rate mortgage notes payable—conventional and tax-exempt	219,010	219,959
Total notes payable and unsecured notes	2,267,217	2,343,076
Variable rate secured short-term debt	32,547	6,278
Variable rate unsecured credit facility	66,800	102,000
Total mortgage notes payable, unsecured notes and unsecured credit facility	$2,366,564	$2,451,354

(1) Balances at December 31, 2005 and 2004 include $818 and $552 of debt discount, respectively, from issuance of unsecured notes.

The following debt activity occurred during the year ended December 31, 2005:

- The Company repaid $150,000 in previously issued unsecured notes in January 2005, along with any unpaid interest, pursuant to their scheduled maturity. No prepayment penalty was incurred;
- The Company issued $100,000 in unsecured notes in March 2005 under its existing shelf registration statement at an annual effective interest rate of 4.999%. Interest on these notes is payable semi-annually on March 15 and September 15, and they mature in March 2013;
- In connection with the admittance of outside investors into the Fund (as defined in Note 6, "Investments in Unconsolidated Entities"), the Company deconsolidated the assets and liabilities of four communities owned by the Fund including $24,869 in fixed rate mortgage debt secured by two of the communities;
- The Company made a payment in the amount of $36,142 to the third-party lender of a joint venture entity that was unconsolidated at December 31, 2004 but was consolidated in March 2005 upon acquisition of the 75% equity interest of the third-party partner; and
- The Company assumed $4,566 in fixed rate debt in connection with the acquisition of a parcel of improved land.

In the aggregate, secured notes payable mature at various dates from September 2007 through April 2043 and are secured by certain apartment communities (with a net carrying value of $689,624 as of December 31, 2005). As of December 31, 2005, the Company has guaranteed approximately $100,844 of mortgage notes payable held by wholly-owned subsidiaries; all such mortgage notes payable are consolidated for financial reporting purposes. The weighted average interest rate of the Company's fixed rate mortgage notes payable (conventional and tax-exempt) was 6.8% at December 31, 2005 and 6.7% at December 31, 2004. The weighted average interest rate of the Company's variable rate mortgage notes payable and its unsecured credit facility (as discussed on the following page), including the effect of certain financing related fees, was 5.5% at December 31, 2005 and 3.8% at December 31, 2004.

Scheduled payments and maturities of mortgage notes payable and unsecured notes outstanding at December 31, 2005 are as follows:

Year	Secured notes payments	Secured notes maturities	Unsecured notes maturities	Stated interest rate of unsecured notes
2006	$ 6,987	$ —	$ 150,000	6.800%
2007	6,741	32,547	110,000	6.875%
			150,000	5.000%
2008	7,155	4,356	50,000	6.625%
			150,000	8.250%
2009	6,141	73,784	150,000	7.500%
2010	4,271	28,989	200,000	7.500%
2011	4,095	7,204	300,000	6.625%
			50,000	6.625%
2012	3,570	12,096	250,000	6.125%
2013	3,513	—	100,000	4.950%
2014	3,754	33,100	150,000	5.375%
2015	4,012	—	—	—
Thereafter	70,678	177,589	—	—
	$120,917	$369,665	$1,810,000	

The Company's unsecured notes contain a number of financial and other covenants with which the Company must comply, including, but not limited to, limits on the aggregate amount of total and secured indebtedness the Company may have on a consolidated basis and limits on the Company's required debt service payments.

The Company has a $500,000 revolving variable rate unsecured credit facility with JPMorgan Chase Bank and Wachovia Bank, N.A. serving as banks and syndication agents for a syndicate of commercial banks and Bank of America, serving as bank and administrative agent. The Company had $66,800 outstanding under the facility and $40,154 in letters of credit

on December 31, 2005 and $102,000 outstanding under the facility and $26,580 in letters of credit on December 31, 2004. Under the terms of the credit facility, the Company may elect to increase the facility by up to an additional $150,000, provided that one or more banks (from the syndicate or otherwise) voluntarily agree to provide the additional commitment. No member of the syndicate of banks can prohibit such increase; such an increase in the facility will only be effective to the extent banks (from the syndicate or otherwise) choose to commit to lend additional funds. The Company pays participating banks, in the aggregate, an annual facility fee of approximately $750. The unsecured credit facility bears interest at varying levels based on the London Interbank Offered Rate ("LIBOR"), rating levels achieved on the Company's unsecured notes and on a maturity schedule selected by the Company. The current stated pricing is LIBOR plus 0.55% per annum (5.94% on December 31, 2005). The spread over LIBOR can vary from LIBOR plus 0.50% to LIBOR plus 1.15% based upon the rating of the Company's long-term unsecured debt. In addition, the unsecured credit facility includes a competitive bid option, which allows banks that are part of the lender consortium to bid to make loans to the Company at a rate that is lower than the stated rate provided by the unsecured credit facility for up to $250,000. The competitive bid option may result in lower pricing if market conditions allow. The Company has $25,000 outstanding under this competitive bid option as of December 31, 2005 priced at LIBOR plus 0.29%, or 4.48%. The Company is subject to (i) certain customary covenants under the unsecured credit facility, including, but not limited to, maintaining certain maximum leverage ratios, a minimum fixed charges coverage ratio and minimum unencumbered assets and equity levels and (ii) prohibitions on paying dividends in amounts that exceed 95% of the Company's Funds from Operations, as defined therein, except as may be required to maintain the Company's REIT status. The credit facility matures in May 2008, assuming exercise of a one-year renewal option by the Company.

4. Stockholders' Equity

As of both December 31, 2005 and 2004, the Company had authorized for issuance 140,000,000 and 50,000,000 shares of common and preferred stock, respectively. As of December 31, 2005 the Company has the following series of redeemable preferred stock outstanding at a stated value of $100,000. This series has no stated maturity and is not subject to any sinking fund or mandatory redemptions.

Series	Shares outstanding December 31, 2005	Payable quarterly	Annual rate	Liquidation preference	Non-redeemable prior to
H	4,000,000	March, June, September, December	8.70%	$25.00	October 15, 2008

Dividends on the preferred stock are cumulative from the date of original issue and are payable quarterly in arrears on or before the 15th day of each month as stated in the table above. The preferred stock is not redeemable prior to the date stated in the table above, but on or after the stated date, may be redeemed for cash at the option of the Company in whole or in part at a redemption price of $25.00 per share, plus all accrued and unpaid dividends, if any.

During the year ended December 31, 2005, the Company (i) issued 903,162 shares of common stock in connection with stock options exercised, (ii) issued 49,263 shares of common stock in exchange for the redemption of an equal number of DownREIT limited partnership units, (iii) issued 13,372 shares to employees under the Employee Stock Purchase Plan, (iv) issued 8,971 shares of common stock to a member of the Board of Directors in fulfillment of a deferred stock award, (v) issued 1,295 shares through the Company's dividend reinvestment plan, (vi) issued 165,790 common shares in connection with stock grants to employees of which 80% are restricted, (vii) had forfeitures of 9,965 shares of restricted stock grants to employees and (viii) withheld 50,916 shares to satisfy employees' tax withholding and other liabilities.

Dividends per common share for the year ended December 31, 2005 were $2.84, and for each of the years ended December 31, 2004 and 2003 were $2.80 per share. In 2005 and 2004, average dividends for all non-redeemed preferred shares during the year were $2.18 per share, and no preferred shares were redeemed. In 2003, average dividends for preferred shares redeemed during the year were $0.27 per share and average dividends for all non-redeemed preferred shares were $2.18 per share.

In 2004, the Company resumed its Dividend Reinvestment and Stock Purchase Plan (the "DRIP"). The DRIP allows for holders of the Company's common stock or preferred stock to purchase shares of common stock through either reinvested

dividends or optional cash payments. The purchase price per share for newly issued shares of common stock under the DRIP will be equal to the last reported sale price for a share of the Company's common stock as reported by the New York Stock Exchange ("NYSE") on the applicable investment date.

5. Derivative Instruments and Hedging Activities

The Company has historically used interest rate swap and cap agreements (collectively, the "Hedged Derivatives") to reduce the impact of interest rate fluctuations on its variable rate, tax-exempt bonds and its variable rate conventional secured debt. The Company has not entered into any interest rate hedge agreements or treasury locks for its conventional unsecured debt and does not hold interest rate hedge agreements for trading or other speculative purposes. As of December 31, 2005, the Hedged Derivatives fix approximately $67,000 of the Company's tax-exempt debt at a weighted average interest rate of 6.3% through interest rate swaps. In addition, as of December 31, 2005, the Company has Hedged Derivatives on approximately $166,000 of its variable rate debt, which floats at a weighted average coupon interest rate of 4.5% and has been capped at a weighted average interest rate of 8.0% through interest rate caps. These Hedged Derivatives have maturity dates ranging from 2007 to 2010. The Hedged Derivatives are accounted for in accordance with SFAS No. 133. SFAS No. 133 requires that every derivative instrument be recorded on the balance sheet as either an asset or liability measured at its fair value, with changes in fair value recognized currently in earnings unless specific hedge accounting criteria are met.

The Company has determined that its Hedged Derivatives qualify as effective cash-flow hedges under SFAS No. 133, resulting in the Company recording the effective portion of changes in the fair value of the Hedged Derivatives in other comprehensive income. Amounts recorded in other comprehensive income will be reclassified into earnings in the period in which earnings are affected by the hedged cash flow. To adjust the Hedged Derivatives to their fair value, the Company recorded unrealized gains to other comprehensive income of $2,626, $1,116 and $4,428 during the years ended December 31, 2005, 2004 and 2003, respectively. The estimated amount, included in accumulated other comprehensive income as of December 31, 2005, expected to be reclassified into earnings within the next twelve months to offset the variability of cash flow during this period is not material.

The Company assesses, both at inception and on an on-going basis, the effectiveness of all hedges in offsetting cash flow of hedged items. Hedge ineffectiveness did not have a material impact on earnings and the Company does not anticipate that it will have a material effect in the future. The fair values of the obligations under the Hedged Derivatives are included in accrued expenses and other liabilities on the accompanying Consolidated Balance Sheets.

By using derivative financial instruments to hedge exposures to changes in interest rates, the Company exposes itself to credit risk and market risk. The credit risk is the risk of a counterparty not performing under the terms of the Hedged Derivatives. The counterparties to these Hedged Derivatives are major financial institutions which have an A+ or better credit rating by the Standard & Poor's Ratings Group. The Company monitors the credit ratings of counterparties and the amount of the Company's debt subject to Hedged Derivatives with any one party. Therefore, the Company believes the likelihood of realizing material losses from counterparty non-performance is remote. Market risk is the adverse effect of the value of financial instruments that results from a change in interest rates. The market risk associated with interest-rate contracts is managed by the establishment and monitoring of parameters that limit the types and degree of market risk that may be undertaken. These risks are managed by the Company's Chief Financial Officer and Senior Vice President–Finance.

6. Investments in Unconsolidated Entities

Investments in Unconsolidated Real Estate Entities As of December 31, 2005, all of the Company's investments in unconsolidated real estate entities were originated prior to and had not been modified since June 29, 2005, and were not considered variable interest entities under FIN 46. Therefore, these investments are accounted for in accordance with SOP 78-9 and APB Opinion No. 18. As of December 31, 2005, the Company had investments in the following real estate entities.

- *Town Run Associates* was formed as a general partnership in November 1994 to develop, own and operate Avalon Run, a 426 apartment-home community located in Lawrenceville, New Jersey. Since formation of this venture, the Company has invested $1,803 and, following a preferred return on all contributed equity (which was not achieved in 2005), has a 40% ownership and cash flow interest with a 49% residual economic interest. The Company is responsible for the day-to-day

operations of the Avalon Run community and is the management agent subject to the terms of a management agreement. The development of Avalon Run was funded entirely through equity contributions from Avalon as well as the other venture partner, and therefore Avalon Run is not subject to any outstanding debt as of December 31, 2005. This community is unconsolidated for financial reporting purposes and is accounted for under the equity method.

- *Town Grove, LLC* was formed as a limited liability corporation in December 1997 to develop, own and operate Avalon Grove, a 402 apartment-home community located in Stamford, Connecticut. Since formation of this venture, the Company has invested $14,653 and, following a preferred return on all contributed equity (which was achieved in 2005), has a 50% ownership and a 50% cash flow and residual economic interest. The Company is responsible for the day-to-day operations of the Avalon Grove community and is the management agent subject to the terms of a management agreement. The development of Avalon Grove was funded through contributions from the Company and the other venture partner, and therefore Avalon Grove is not subject to any outstanding debt as of December 31, 2005. This community is unconsolidated for financial reporting purposes and is accounted for under the equity method.
- *Avalon Terrace, LLC*—The Company acquired Avalon Bedford, a 368 apartment-home community located in Stamford, Connecticut in December 1998. In May 2000, the Company transferred Avalon Bedford to Avalon Terrace, LLC and subsequently admitted a joint venture partner, while retaining a 25% ownership interest in this limited liability company for an investment of $5,394 and a right to 50% of cash flow distributions after achievement of a threshold return (which was not achieved in 2005). The Company is responsible for the day-to-day operations of the Avalon Bedford community and is the management agent subject to the terms of a management agreement. In 2005, Avalon Bedford refinanced its outstanding debt. As of December 31, 2005, Avalon Bedford has $37,200 in 5.2% fixed rate debt outstanding, which matures in November 2010. As part of the refinancing, the Company received a distribution of $3,714. Avalon Bedford's debt is neither guaranteed by nor recourse to the Company. This community is unconsolidated for financial reporting purposes and is accounted for under the equity method.
- *Arna Valley View LP*—In connection with the municipal approval process for the development of a consolidated community, the Company agreed to participate in the formation of a limited partnership in February 1999 to develop, finance, own and operate Arna Valley View, a 101 apartment-home community located in Arlington, Virginia. This community has affordable rents for 100% of apartment homes related to the tax-exempt bond financing and tax credits used to finance construction of the community. A subsidiary of the Company is the general partner of the partnership with a 0.01% ownership interest. The Company is responsible for the day-to-day operations of the community and is the management agent subject to the terms of a management agreement. As of December 31, 2005, Arna Valley View has $5,843 of variable rate, tax-exempt bonds outstanding, which mature in June 2032. In addition, Arna Valley View has $4,805 of 4% fixed rate county bonds outstanding that mature in December 2030. Arna Valley View's debt is neither guaranteed by nor recourse to the Company. Due to the Company's limited ownership and investment in this venture, it is accounted for using the cost method.
- *CVP I, LLC*—In February 2004, the Company entered into a joint venture agreement with an unrelated third-party for the development of Avalon Chrystie Place I, a 361 apartment-home community located in New York, New York, for which construction was completed in late 2005. The Company has contributed $6,270 to this joint venture and holds a 20% equity interest (with a right to 50% of distributions after achievement of a threshold return, which was not achieved in 2005). The Company is the managing member of CVP I, LLC, however property management services at the community are performed by a third party. As of December 31, 2005, CVP I, LLC has a variable rate construction loan in the amount of $117,000 outstanding which matures in February 2009. In connection with the general contractor services that the Company provided to CVP I, LLC during the development of Avalon Chrystie Place I, the Company has provided a construction completion guarantee to the construction loan lender in order to fulfill their standard financing requirements related to the construction financing. Under the terms of the guarantee, in the event of default, the Company would be required to make payment for any excess cost to complete construction over any undisbursed loan proceeds. The obligation of the Company under this guarantee will terminate once all of the lender's standard completion requirements have been satisfied, which the Company expects to occur in early 2006. As construction of Avalon Chrystie Place I is complete, no liability for this guarantee is recorded as of December 31, 2005. This community is unconsolidated for financial reporting purposes and is accounted for under the equity method.
- *Avalon Del Rey Apartments, LLC*—In March 2004, the Company entered into an agreement with an unrelated third-party which provides that, after the Company completes construction of Avalon Del Rey, the community will be owned and operated by a joint venture between the Company and the third-party. Avalon Del Rey, if developed as expected, will be a 309 apartment-home community located in Los Angeles, California. Upon construction completion, the third-party

venture partner will invest $49,000 and will be granted a 70% ownership interest in the venture, with the Company retaining a 30% equity interest. The Company will be responsible for the day-to-day operations of the community and will be the management agent subject to the terms of a management agreement. Avalon Del Rey Apartments, LLC has a variable rate $50,000 secured construction loan, of which $32,547 is outstanding as of December 31, 2005 and which matures in September 2007. In conjunction with the general contractor services that the Company provides to Avalon Del Rey Apartments, LLC, the Company has provided a construction completion guarantee to the construction loan lender in order to fulfill their standard financing requirements related to construction financing. The obligation of the Company under this guarantee will terminate following construction completion once all of the lender's standard completion requirements have been satisfied, which the Company expects to occur in 2007. The Company consolidates this community for financial reporting purposes since it holds a 100% equity interest. However, the Company expects this community to be unconsolidated for financial reporting purposes in periods subsequent to the contribution by the third-party venture partner.

- *Juanita Construction, Inc.*—In April 2004, the Company entered into an agreement to develop Avalon at Juanita Village, a 211 apartment-home community located in Kirkland, Washington, for which construction was completed in late 2005. Avalon at Juanita Village was developed through Juanita Construction, Inc., a wholly-owned taxable REIT subsidiary and, upon completion of certain conditions precedent to closing, will contribute the community to a joint venture. Upon contribution of the community to the joint venture, the Company expects to be reimbursed for all costs incurred to develop the community (approximately $45,300). The third-party joint venture partner will receive a 100% equity interest in the joint venture and will manage the joint venture. The Company will receive a residual profits interest and will be engaged to manage the community for a property management fee. The Company consolidates this community for financial reporting purposes since it holds a 100% equity interest. However, the Company expects this community to be unconsolidated for financial reporting purposes after it is contributed to the joint venture.
- *Mission Bay Venture Partners, LLC*—In December 2004, the Company entered into a joint venture agreement with an unrelated third-party for the development of Avalon at Mission Bay North II. Avalon at Mission Bay North II, if developed as expected, will be a 313 apartment-home community located in San Francisco, California. The Company has contributed $5,902 to this venture and holds a 25% equity interest. The Company will be responsible for the day-to-day operations of the community and will be the management agent subject to the terms of a management agreement. Mission Bay Venture Partners, LLC has a variable rate $94,400 secured construction loan, of which $28,354 is outstanding as of December 31, 2005 and which matures in September 2010, assuming exercise of two one-year extensions. In conjunction with the general contractor services that the Company provides to Mission Bay Venture Partners, LLC, the Company has provided a construction completion guarantee to the construction loan lender in order to fulfill their standard financing requirements related to construction financing. Under the terms of the guarantee, in the event of default, the Company would be required to make payment for any excess cost to complete construction over any undisbursed loan proceeds. The obligation of the Company under this guarantee will terminate following construction completion once all of the lender's standard completion requirements have been satisfied, which the Company expects to occur in 2007. The Company does not expect there to be any excess cost to complete construction, as the construction of Avalon at Mission Bay North II is currently on budget, therefore no liability for this guarantee has been recorded by the Company at December 31, 2005. This community is unconsolidated for financial reporting purposes and is accounted for under the equity method.
- *AvalonBay Value Added Fund, L.P., (the "Fund")*—In March 2005, the Company admitted outside investors into the Fund, a private, discretionary investment vehicle, which will acquire and operate communities in the Company's markets. The Fund will serve, until March 16, 2008 or until 80% of its committed capital is invested, as the exclusive vehicle through which the Company will acquire apartments communities, subject to certain exceptions. The Fund has nine institutional investors, including the Company, and combined capital commitments of $330,000. A significant portion of the investments made in the Fund by its investors are being made through AvalonBay Value Added Fund, Inc., a Maryland corporation that will qualify as a REIT under the Internal Revenue Code (the "Fund REIT"). A wholly-owned subsidiary of the Company is the general partner of the Fund and has committed $50,000 to the Fund and the Fund REIT, representing a 15.2% combined general partner and limited partner equity interest, with $11,581 of this commitment funded as of December 31, 2005. Under the Fund documents, the Fund has the ability to employ leverage of up to 65% on a portfolio basis, which, if achieved, would enable the Fund to invest up to approximately $940,000. Upon the admittance of the outside investors, the Fund held four communities, containing a total of 879 apartment homes with an aggregate gross real estate value of $112,852, that were acquired in 2004. Prior to the admittance of outside investors, the Fund was directly or

indirectly wholly-owned by the Company, and therefore the revenues and expenses, and assets and liabilities of these four communities were consolidated in the Company's results of operations and financial position. However, upon admittance of the outside investors in March 2005, the Company deconsolidated the revenue and expenses, and assets and liabilities of these four communities and accounts for its 15.2% equity interest in the Fund under the equity method of accounting. Although the Company holds less than a 20% equity interest in the Fund, the Company accounts for the Fund under the equity method due to its significant influence over the Fund. The Company received net proceeds of $87,948 as reimbursement for acquiring and warehousing these communities. The Company receives asset management fees, property management fees and redevelopment fees, as well as a promoted interest if certain thresholds are met (which were not achieved in 2005).

As of December 31, 2005, the Fund owns the following communities, subject to certain mortgage debt. In addition, as of December 31, 2005, the Fund has $37,100 outstanding under its variable rate credit facility, which matures in January 2008. The Company has not guaranteed the debt, nor does it have any obligation to fund this debt should the Fund be unable to do so.

- Avalon at Redondo Beach, a 105 apartment-home community located in Los Angeles, California. As of December 31, 2005, Avalon at Redondo Beach has $16,765 in 4.8% fixed rate debt outstanding, which matures in October 2011;
- Avalon Lakeside, a 204 apartment-home community located in Chicago, Illinois. As of December 31, 2005, Avalon Lakeside has $7,960 in 6.9% fixed rate debt outstanding, which matures in February 2028 (but can be prepaid after February 2008 without penalty);
- Avalon Columbia, a 170 apartment-home community located in Baltimore, Maryland. As of December 31, 2005, Avalon Columbia has $16,575 in 5.3% fixed rate debt outstanding, which matures in April 2012;
- Ravenswood at the Park, a 400 apartment-home community located in Chicago, Illinois. As of December 31, 2005, Ravenswood at the Park has $31,500 in 5.0% fixed rate debt outstanding, which matures in July 2012;
- Avalon at Poplar Creek, a 196 apartment-home community located in Chicago, Illinois. As of December 31, 2005, Avalon at Poplar Creek has $16,500 in 4.8% fixed rate debt outstanding, which matures in October 2012;
- Fuller Martel, an 82 apartment-home community located in Los Angeles, California;
- Civic Center Place, a 192 apartment-home community located in Norwalk, California. As of December 31, 2005, Civic Center Place has $23,806 in 5.3% fixed rate debt outstanding, which matures in August 2013; and
- Paseo Park, a 134 apartment-home community located in Fremont, California.

In addition, as part of the formation of the Fund, the Company has provided to one of the limited partners a guarantee. The guarantee provides that, if, upon final liquidation of the Fund, the total amount of all distributions to that partner during the life of the Fund (whether from operating cash flow or property sales) does not equal the total capital contributions made by that partner, then the Company will pay the partner an amount equal to the shortfall, but in no event more than 10% of the total capital contributions made by the partner (maximum of approximately $1,700 as of December 31, 2005). The Company has not recorded a liability related to this guarantee as of December 31, 2005, as the fair value of the real estate assets owned by the Fund is considered adequate to cover such payment under a liquidation scenario.

The following is a combined summary of the financial position of the entities accounted for using the equity method, as of the dates presented:

	12-31-05	12-31-04
Assets:		
Real estate, net	$491,919	$221,236
Other assets	86,247	86,821
Total assets	$578,166	$308,057
Liabilities and partners' equity:		
Mortgage notes payable and credit facility	$349,260	$139,500
Other liabilities	27,497	32,579
Partners' equity	201,409	135,978
Total liabilities and partners' equity	$578,166	$308,057

The following is a combined summary of the operating results of the entities accounted for using the equity method, for the years presented:

	For the year ended		
	12-31-05	12-31-04	12-31-03
Rental income	$37,133	$21,148	$20,939
Operating and other expenses	(20,364)	(8,291)	(8,038)
Interest expense, net	(7,585)	(1,786)	(1,688)
Depreciation expense	(8,875)	(4,003)	(3,986)
Net income	$ 309	$ 7,068	$ 7,227

In March 2005, the Company purchased its joint venture partner's interest in AvalonBay Redevelopment, LLC, the limited liability company that owns Avalon on the Sound. Avalon on the Sound, a 412 apartment-home community located in the New York, New York metropolitan area, was developed through the joint venture in 2001. The Company purchased the third-party partner's 75% equity interest in the joint venture for a gross purchase price (including the impact of the Company's share of promoted interest) of $84,521. After consideration of the third-party partner's pro rata share of outstanding debt, as well as the Company's share of promoted interest, the net purchase price was $57,415. In conjunction with the purchase transaction, the third-party lender to the limited liability company received a payment of $36,142 in consideration of the outstanding debt, of which $9,036 was the Company's share of such payment. Prior to December 31, 2004, the Company had a repurchase option for Avalon on the Sound and accounted for its investment as a profit-sharing arrangement as required by SFAS No. 66, "Accounting for Sales of Real Estate." As a result, the revenues and expenses, and assets and liabilities of Avalon on the Sound were included in the Company's Consolidated Financial Statements for periods prior to December 31, 2004. The income allocated to the controlling partner is shown as venture partner interest in profit-sharing on the Company's Consolidated Statements of Operations and Other Comprehensive Income for the years ended December 31, 2004 and 2003. The repurchase option expired in December 2004, and therefore as of December 31, 2004 and for the three months ended March 31, 2005, the Company accounted for its 25% interest in Avalon on the Sound under the equity method of accounting. Due to the purchase of the remaining 75% equity interest, this entity is consolidated as of December 31, 2005 and for the period from April 1, 2005 through December 31, 2005.

Investments in Unconsolidated Non-Real Estate Entities At December 31, 2004, the Company held a minority interest investment in one non-real estate entity, which was a technology investment (Rent.com). Based on ownership and control criteria, the Company accounted for this investment using the cost method. In February 2005, this technology investment was acquired by a third-party. As a result of this transaction, the Company received net proceeds of approximately $6,700 and recognized a gain on the sale of this investment of $6,252, which is reflected in equity in income of unconsolidated entities on the accompanying Consolidated Statement of Operations and Other Comprehensive Income for the year ended December 31, 2005.

The following is a summary of the Company's equity in income of unconsolidated entities for the years presented:

	For the year ended		
	12-31-05	12-31-04	12-31-03
Town Grove, LLC	$1,286	$ 950	$ 1,158
Falkland Partners, LLC[1]	—	—	24,255
Avalon at Chrystie Place	(339)	—	—
Town Run Associates	266	43	214
Avalon Terrace, LLC	58	(28)	(21)
Avalon at Mission Bay North II	(57)	—	—
AvalonBay Value Added Fund, L.P.	(341)	—	—
Avalon on the Sound	73	—	—
Rent.com	6,252	135	(71)
Total	$7,198	$1,100	$25,535

[1] The activity for the year ended December 31, 2003 includes the Company's share of the GAAP gain reported by Falkland Partners, LLC as a result of the sale of Falkland Chase in the amount of $21,816 and the liquidation of the limited liability company's assets in the amount of $1,632. The sale of Falkland Chase resulted in net proceeds to the Company of $16,729.

7. Discontinued Operations—Real Estate Assets Sold or Held for Sale

During the year ended December 31, 2005, the Company sold seven communities, containing a total of 1,305 apartment homes. These communities were sold for a gross sales price of approximately $351,450, resulting in net proceeds of $344,185 and a GAAP gain of $192,469. Details regarding the community asset sales are summarized in the following table:

Community Name	Location	Period of sale	Apartment homes	Debt	Gross sales price	Net proceeds
Avalon at Penasquitos Hills	San Diego, CA	1Q05	176	$ —	$ 34,250	$ 33,657
Avalon Sunnyvale	Sunnyvale, CA	1Q05	220	—	45,000	44,324
Avalon Lake	Danbury, CT	2Q05	135	—	37,700	36,869
Avalon Crossing	Rockville, MD	3Q05	132	—	44,500	43,896
Avalon Fremont II	Fremont, CA	3Q05	135	—	39,500	38,723
Avalon Wildwood	Lynnwood, WA	3Q05	238	—	44,500	43,047
The Tower at Avalon Cove	Jersey City, NJ	4Q05	269	—	106,000	103,669
Total of all 2005 asset sales			1,305	$ —	$351,450	$344,185
Total of all 2004 asset sales			1,360	$38,735	$241,050	$210,001
Total of all 2003 asset sales			3,184	$39,665	$424,650	$379,789

As of December 31, 2005, the Company had three communities that qualified as held for sale under the provisions of SFAS No. 144. The Company anticipates selling these communities in the next twelve months. As required under SFAS No. 144, the operations for any communities sold from January 1, 2003 through December 31, 2005 and communities held for sale as of December 31, 2005 have been presented as discontinued operations in the accompanying Consolidated Financial Statements. Accordingly, certain reclassifications have been made in prior years to reflect discontinued operations consistent with current year presentation. The following is a summary of income from discontinued operations for the years presented:

	For the year ended		
	12-31-05	12-31-04	12-31-03
Rental income	$26,867	$ 48,018	$ 75,981
Operating and other expenses	(8,684)	(15,646)	(26,705)
Interest expense, net	—	(525)	(2,399)
Minority interest expense	—	(37)	(438)
Depreciation expense	(3,241)	(10,676)	(15,071)
Income from discontinued operations	$14,942	$ 21,134	$ 31,368

The Company's Consolidated Balance Sheets include other assets (excluding net real estate) of $485 and $1,497, and other liabilities of $1,837 and $3,407 as of December 31, 2005 and December 31, 2004, respectively, relating to real estate assets sold or held for sale. The estimated proceeds less anticipated costs to sell the real estate assets held for sale as of December 31, 2005 are greater than the carrying value as of December 31, 2005, and therefore no provision for possible loss was recorded.

During the year ended December 31, 2005, the Company decided to relocate one of its regional offices and as a result sold an office building in Connecticut. This office building, which was owned through a limited partnership in which the Company is the general partner with majority ownership, was sold for a purchase price of $7,650, resulting in a GAAP gain of $2,818. In addition, the Company sold three parcels of land, one located in Dublin, California, one in Madison, Washington and one in Freehold, New Jersey, for an aggregate gross sales price of $23,620 and an aggregate GAAP gain of $4,479. The Company recorded an impairment loss in the amount of $3,000 in 2002 related to one of these land parcels to reflect the land at fair value based on its entitlement status at the time it was determined to be land held for sale.

8. Commitments and Contingencies

Employment Agreements and Arrangements As of December 31, 2005, the Company had employment agreements with four executive officers. The employment agreements provide for severance payments and generally provide for accelerated vesting of stock options and restricted stock in the event of a termination of employment (except for a termination by the Company with cause or a voluntary termination by the employee). The current terms of these agreements ends on dates that vary between November 2006 and June 2007. The employment agreements provide for one-year automatic renewals (two years in the case of the Chief Executive Officer ("CEO")) after the initial term unless an advance notice of non-renewal is provided by either party. Upon a notice of non-renewal by the Company, each of the officers may terminate his employment and receive a severance payment. Upon a change in control, the agreements provide for an automatic extension of up to three years from the date of the change in control. The employment agreements provide for base salary and incentive compensation in the form of cash awards, stock options and stock grants subject to the discretion of, and attainment of performance goals established by, the Compensation Committee of the Board of Directors.

In February 2005, the Company announced certain management changes including the departure of a senior executive who became entitled to severance benefits in accordance with the terms of his employment agreement with the Company. The Company entered into an agreement with this executive regarding his departure that is consistent with the terms of his employment agreement and provides for a consulting arrangement for up to one year. The Company recorded a charge of approximately $2,100 in the year ended December 31, 2005 related to cash payments associated with this agreement. This charge is included in general and administrative expense on the accompanying Consolidated Statements of Operations and Other Comprehensive Income.

The Company's stock incentive plan, as described in Note 10, "Stock-Based Compensation Plans," provides that upon an employee's Retirement (as defined in the plan documents) from the Company, all outstanding stock options and restricted shares of stock held by the employee will vest, and the employee will have up to 12 months to exercise any options held upon retirement. Under the plan, Retirement means a termination of employment, other than for cause, after attainment of age 50, provided that (i) the employee has worked for the Company for at least 10 years, (ii) the employee's age at Retirement plus years of employment with the Company equals at least 70, (iii) the employee provides at least six months written notice of his intent to retire, and (iv) the employee enters into a one year non-compete and employee non-solicitation agreement.

The Company also has an Officer Severance Program (the "Program") for the benefit of those officers of the Company who do not have employment agreements. Under the Program, in the event an officer who is not otherwise covered by a severance arrangement is terminated (other than for cause) within two years of a change in control (as defined) of the Company, such officer will generally receive a cash lump sum payment equal to the sum of such officer's base salary and cash bonus, as well as accelerated vesting of stock options and restricted stock. Costs related to the Company's employment agreements and the Program are accounted for in accordance with SFAS No. 5, "Accounting for Contingencies," and therefore are recognized when considered by management to be probable and estimable.

Legal Contingencies The Company is subject to various legal proceedings and claims that arise in the ordinary course of business. These matters are frequently covered by insurance. If it has been determined that a loss is probable to occur, the estimated amount of the loss is expensed in the financial statements. While the resolution of these matters cannot be predicted with certainty, management believes the final outcome of such matters will not have a material adverse effect on the financial position or results of operations of the Company.

The Company is currently involved in construction litigation with a general contractor and a surety bond provider related to a community that has since completed development. A non-jury trial ended in April 2004, and in May 2004, the court issued a ruling, finding that these parties were liable to the Company for consequential damages due to breach of contract and other failures to perform. The court issued a ruling in October 2004, awarding the Company approximately $1,250 plus interest. In September 2005, the Company filed an appeal to seek an increase in the damage award and the general contractor and surety has filed an appeal seeking a reduction. There is no guarantee that a higher, or any, damage award, will be received by the Company after all appeals are filed and a final ruling is provided.

The Company is currently involved in a lawsuit regarding the handling of security deposits in California. The lawsuit alleges that the amounts withheld by the Company from security deposits at the end of tenancies exceeded the Company's actual damages. The Company has agreed with the plaintiff on the terms of a settlement with the purported class. The settlement terms have been approved by the court, subject to final certification and approval after administration of the settlement, which is expected in April 2006. During the year ended December 31, 2005, the Company accrued $1,500 related to this and other various litigation matters.

On September 23, 2005, the Equal Rights Center, an advocacy group for the disabled, filed a lawsuit against the Company alleging that communities constructed by the Company violate the accessibility requirements of the Fair Housing Act and the Americans with Disabilities Act. The lawsuit seeks monetary damages as well as injunctive relief, such as modifications to existing assets. Due to the preliminary nature of the litigation, the Company cannot predict or determine the outcome of this lawsuit, nor is it reasonably possible to estimate the amount of loss, if any, that would be associated with an adverse decision.

Lease Obligations The Company owns five apartment communities which are located on land subject to land leases expiring between July 2029 and March 2142. In addition, the Company leases certain office space. These leases are accounted for as operating leases in accordance with SFAS No. 13, "Accounting for Leases." These leases have varying escalation terms, and three of these leases have purchase options exercisable between 2006 and 2052. The Company incurred costs of $4,486, $4,399 and $3,348 in the years ended December 31, 2005, 2004 and 2003, respectively, related to these leases.

The following table details the future minimum lease payments under the Company's current operating leases:

Payments due by period

2006	2007	2008	2009	2010	Thereafter
$3,454	$3,495	$3,420	$2,986	$3,058	$1,168,680

During the year ended December 31, 2005, the Company executed a purchase option on one of its land leases, for a purchase price of approximately $14,000. Lease payments for this lease totaled $880 for the year ended December 31, 2005.

9. Segment Reporting

The Company's reportable operating segments include Established Communities, Other Stabilized Communities, and Development/Redevelopment Communities. Annually as of January 1st, the Company determines which of its communities fall into each of these categories and maintains that classification, unless disposition plans regarding a community change, throughout the year for the purpose of reporting segment operations.

- *Established Communities (also known as Same Store Communities)* are communities where a comparison of operating results from the prior year to the current year is meaningful, as these communities were owned and had stabilized occupancy and operating expenses as of the beginning of the prior year. For the year 2005, the Established Communities are communities that are consolidated for financial reporting purposes, had stabilized occupancy and operating expenses as of January 1, 2004, are not conducting or planning to conduct substantial redevelopment activities and are not held for sale or planned for disposition within the current year. A community is considered to have stabilized occupancy at the earlier of (i) attainment of 95% physical occupancy or (ii) the one-year anniversary of completion of development or redevelopment.
- *Other Stabilized Communities* includes all other completed communities that have stabilized occupancy, as defined above. Other Stabilized Communities do not include communities that are conducting or planning to conduct substantial redevelopment activities within the current year.
- *Development/Redevelopment Communities* consists of communities that are under construction and have not received a final certificate of occupancy, communities where substantial redevelopment is in progress or is planned to begin during the current year and communities under lease-up, that had not reached stabilized occupancy, as defined above, as of January 1, 2005.

In addition, the Company owns land held for future development and has other corporate assets that are not allocated to an operating segment.

SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," requires that segment disclosures present the measure(s) used by the chief operating decision maker for purposes of assessing such segments' performance. The Company's chief operating decision maker is comprised of several members of its executive management team who use Net Operating Income ("NOI") as the primary financial measure for Established and Other Stabilized Communities. NOI is defined by the Company as total revenue less direct property operating expenses, including property taxes, and excludes corporate-level property management and other indirect operating expenses, investments and investment management, interest income and expense, general and administrative expense, equity in income of unconsolidated entities, minority interest in consolidated partnerships, venture partner interest in profit-sharing, depreciation expense, cumulative effect of change in accounting principle, gain on sale of real estate assets and income from discontinued operations. Although the Company considers NOI a useful measure of a community's or communities' operating performance, NOI should not be considered an alternative to net income or net cash flow from operating activities, as determined in accordance with GAAP.

A reconciliation of NOI to net income for the years ended December 31, 2005, 2004 and 2003 is as follows:

	For the year ended		
	12-31-05	12-31-04	12-31-03
Net income	$ 322,378	$ 219,745	$ 271,525
Corporate-level property management and other indirect operating expenses	31,243	27,956	27,123
Corporate-level other income	(4,568)	(1,344)	(1,520)
Investments and investment management	4,834	4,690	2,948
Interest expense, net	127,099	131,103	130,178
General and administrative expense	25,761	18,074	14,830
Equity in income of unconsolidated entities	(7,198)	(1,100)	(25,535)
Minority interest in consolidated partnerships	1,481	150	950
Venture partner interest in profit-sharing	—	1,178	1,688
Depreciation expense	158,822	151,991	138,725
Cumulative effect of change in accounting principle	—	(4,547)	—
Gain on sale of real estate assets	(199,766)	(122,425)	(160,990)
Income from discontinued operations	(14,942)	(21,134)	(31,368)
Net operating income	$ 445,144	$ 404,337	$ 368,554

The primary performance measure for communities under development or redevelopment depends on the stage of completion. While under development, management monitors actual construction costs against budgeted costs as well as lease-up pace and rent levels compared to budget.

The table on the following page provides details of the Company's segment information as of the dates specified. The segments are classified based on the individual community's status as of the beginning of the given calendar year. Therefore, each year the composition of communities within each business segment is adjusted. Accordingly, the amounts between years are not directly comparable. The accounting policies applicable to the operating segments described above are the same as those described in Note 1, "Organization and Significant Accounting Policies." Segment information for the years ending December 31, 2005, 2004 and 2003 has been adjusted for the communities that were sold from January 1, 2003 through December 31, 2005 as described in Note 7, "Discontinued Operations—Real Estate Assets Sold or Held for Sale."

	Total revenue	NOI	% NOI change from prior year	Gross real estate[1]
For the year ended December 31, 2005				
Established				
Northeast	$167,636	$111,734	3.5%	$1,062,981
Mid-Atlantic	68,575	48,613	3.9%	387,801
Midwest	11,113	6,627	7.1%	91,755
Pacific Northwest	30,080	19,312	8.0%	315,331
Northern California	146,432	99,769	3.5%	1,489,363
Southern California	48,800	35,319	6.7%	331,315
Total Established	472,636	321,374	4.2%	3,678,546
Other Stabilized	77,552	50,621	n/a	653,399
Development / Redevelopment	116,144	73,149	n/a	1,259,371
Land Held for Future Development	n/a	n/a	n/a	188,414
Non-allocated[2]	4,348	n/a	n/a	22,066
Total	$670,680	$445,144	10.1%	$5,801,796
For the year ended December 31, 2004				
Established				
Northeast	$135,059	$ 89,547	(2.5%)	$ 722,482
Mid-Atlantic	51,390	36,316	(0.2%)	273,774
Midwest	10,734	6,188	6.8%	91,121
Pacific Northwest	28,836	17,874	1.1%	314,717
Northern California	126,196	87,067	(5.9%)	1,270,848
Southern California	56,124	39,634	1.8%	401,204
Total Established	408,339	276,626	(1.2%)	3,074,146
Other Stabilized	111,894	71,744	n/a	1,068,859
Development / Redevelopment	93,096	55,967	n/a	1,074,733
Land Held for Future Development	n/a	n/a	n/a	156,350
Non-allocated[2]	515	n/a	n/a	27,401
Total	$613,844	$404,337	9.7%	$5,401,489
For the year ended December 31, 2003				
Established				
Northeast	$136,132	$ 89,383	(9.2%)	$ 767,035
Mid-Atlantic	57,014	40,159	(4.5%)	307,777
Midwest	16,141	8,553	(16.7%)	140,631
Pacific Northwest	24,410	15,015	(12.1%)	264,760
Northern California	126,484	89,878	(11.9%)	1,219,242
Southern California	41,051	28,851	(20.4%)	290,192
Total Established	401,232	271,839	(11.2%)	2,989,637
Other Stabilized	77,370	52,152	n/a	706,601
Development / Redevelopment	77,714	44,563	n/a	1,197,218
Land Held for Future Development	n/a	n/a	n/a	81,358
Non-allocated[2]	1,197	n/a	n/a	23,946
Total	$557,513	$368,554	(0.2%)	$4,998,760

[1] Does not include gross real estate assets for discontinued operations of $101,372, $295,655 and $432,997 as of December 31, 2005, 2004 and 2003 respectively.

[2] Revenue represents third-party management, accounting and developer fees and miscellaneous income which are not allocated to a reportable segment.

10. Stock-Based Compensation Plans

The Company has a stock incentive plan (the "1994 Plan"), which was amended and restated on December 8, 2004. Individuals who are eligible to participate in the 1994 Plan include officers, other associates, outside directors and other key persons of the Company and its subsidiaries who are responsible for or contribute to the management, growth or profitability of the Company and its subsidiaries. The 1994 Plan authorizes (i) the grant of stock options that qualify as incentive stock

options (“ISOs”) under Section 422 of the Internal Revenue Code, (ii) the grant of stock options that do not so qualify, (iii) grants of shares of restricted and unrestricted common stock, (iv) grants of deferred stock awards, (v) performance share awards entitling the recipient to acquire shares of common stock and (vi) dividend equivalent rights.

Shares of common stock of 2,066,308, 2,311,249 and 2,358,393 were available for future option or restricted stock grant awards under the 1994 Plan as of December 31, 2005, 2004 and 2003, respectively. Annually, on January 1st, the maximum number available for issuance under the 1994 Plan is increased by between 0.48% and 1.00% of the total number of shares of common stock and DownREIT units actually outstanding on such date. Notwithstanding the foregoing, the maximum number of shares of stock for which ISOs may be issued under the 1994 Plan shall not exceed 2,500,000 and no awards shall be granted under the 1994 Plan after May 11, 2011. Options and restricted stock granted under the 1994 Plan vest and expire over varying periods, as determined by the Compensation Committee of the Board of Directors.

Before the Merger, Avalon had adopted its 1995 Equity Incentive Plan (the “Avalon 1995 Incentive Plan”). Under the Avalon 1995 Incentive Plan, a maximum number of 3,315,054 shares (or 2,546,956 shares as adjusted for the Merger) of common stock were issuable, plus any shares of common stock represented by awards under Avalon’s 1993 Stock Option and Incentive Plan (the “Avalon 1993 Plan”) that were forfeited, canceled, reacquired by Avalon, satisfied without the issuance of common stock or otherwise terminated (other than by exercise). Options granted to officers, non-employee directors and associates under the Avalon 1995 Incentive Plan generally vested over a three-year term, expire ten years from the date of grant and are exercisable at the market price on the date of grant.

In connection with the Merger, the exercise prices and the number of options under the Avalon 1995 Incentive Plan and the Avalon 1993 Plan were adjusted to reflect the equivalent Bay shares and exercise prices based on the 0.7683 share conversion ratio used in the Merger. Officers, non-employee directors and associates with Avalon 1995 Incentive Plan or Avalon 1993 Plan options may exercise their adjusted number of options for the Company’s common stock at the adjusted exercise price. As of June 4, 1998, the date of the Merger, options and other awards ceased to be granted under the Avalon 1993 Plan or the Avalon 1995 Incentive Plan. Accordingly, there were no options to purchase shares of common stock available for grant under the Avalon 1995 Incentive Plan or the Avalon 1993 Plan at December 31, 2005, 2004 or 2003.

Information with respect to stock options granted under the 1994 Plan, the Avalon 1995 Incentive Plan and the Avalon 1993 Plan is as follows:

	1994 Plan shares	Weighted average exercise price per share	Avalon 1995 and Avalon 1993 Plan shares	Weighted average exercise price per share
Options Outstanding, December 31, 2002	3,166,007	$39.05	640,506	$35.27
Exercised	(454,843)	32.36	(165,264)	29.39
Granted	425,101	37.14	—	—
Forfeited	(157,000)	43.45	(1,280)	34.07
Options Outstanding, December 31, 2003	2,979,265	$39.57	473,962	$37.32
Exercised	(1,167,679)	39.06	(287,700)	37.05
Granted	545,809	50.71	—	—
Forfeited	(80,577)	43.98	—	—
Options Outstanding, December 31, 2004	2,276,818	$42.39	186,262	$36.23
Exercised	(743,524)	41.89	(159,638)	37.82
Granted	725,988	70.09	—	—
Forfeited	(29,504)	55.66	—	—
Options Outstanding, December 31, 2005	2,229,778	$51.40	26,624	$37.09
Options Exercisable:				
December 31, 2003	2,069,704	$38.51	473,962	$37.32
December 31, 2004	1,366,009	$39.72	186,262	$38.15
December 31, 2005	1,158,591	$42.45	26,624	$37.09

For options outstanding at December 31, 2005 under the 1994 Plan, 653,310 options had exercise prices ranging between $31.50 and $39.99 and a weighted average remaining contractual life of 4.1 years, 425,308 options had exercise prices ranging between $40.00 and $49.99 and a weighted average remaining contractual life of 5.7 years, 441,408 options had exercise prices between $50.00 and $59.99 and a weighted average remaining contractual life of 8.13 years, 705,252 options had exercise prices ranging between $69.93 and $79.99 and a weighted average remaining contractual life of 9.3 years, and 4,500

options had exercise prices between $80.00 and $86.65 and a weighted average remaining contractual life of 9.72 years. Options outstanding at December 31, 2005 for the Avalon 1993 and Avalon 1995 Plans had exercise prices ranging from $28.15 to $37.66 and a weighted average contractual life of 2 years.

Effective January 1, 2003, the Company adopted the fair value recognition provisions of SFAS No. 123 prospectively to all employee awards granted, modified, or settled on or after January 1, 2003. The effect on net income available to common stockholders and earnings per share if the fair value based method had been applied to all outstanding and unvested awards in each year based on the fair market value as determined on the date of grant is reflected in Note 1, "Organization and Significant Accounting Policies."

The weighted average fair value of the options granted during 2005 is estimated at $6.40 per share on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of 5.5% over the expected life of the option, volatility of 17.56%, risk-free interest rates of 3.91% and an expected life of approximately 7 years. The weighted average fair value of the options granted during 2004 is estimated at $3.87 per share on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of 6.05% over the expected life of the option, volatility of 17.28%, risk-free interest rates of 3.58% and an expected life of approximately 7 years. The weighted average fair value of the options granted during 2003 is estimated at $1.94 per share on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions: dividend yield of 7.56% over the expected life of the option, volatility of 18.68%, risk-free interest rates of 3.31% and an expected life of approximately 7 years. The cost related to stock-based employee compensation for employee stock options included in the determination of net income is based on actual forfeitures for the given year.

In October 1996, the Company adopted the 1996 Non-Qualified Employee Stock Purchase Plan (as amended, the "ESPP"). Initially 1,000,000 shares of common stock were reserved for issuance under this plan. There are currently 800,142 shares remaining available for issuance under the plan. Full-time employees of the Company generally are eligible to participate in the ESPP if, as of the last day of the applicable election period, they have been employed by the Company for at least one month. All other employees of the Company are eligible to participate provided that as of the applicable election period they have been employed by the Company for twelve months. Under the ESPP, eligible employees are permitted to acquire shares of the Company's common stock through payroll deductions, subject to maximum purchase limitations. The purchase period is a period of seven months beginning each April 1 and ending each October 30. The purchase price for common stock purchased under the plan is 85% of the lesser of the fair market value of the Company's common stock on the first day of the applicable purchase period or the last day of the applicable purchase period. The offering dates, purchase dates and duration of purchase periods may be changed by the Board of Directors, if the change is announced prior to the beginning of the affected date or purchase period. The Company issued 13,372 shares, 14,476 shares and 14,393 shares and recognized compensation expense of $134, $109 and $95 under the ESPP for the years ended December 31, 2005, 2004 and 2003, respectively. The Company accounts for transactions under the ESPP using the fair value method prescribed under SFAS No. 123, as further discussed in Note 1, "Organization and Significant Accounting Policies."

11. Fair Value of Financial Instruments

Cash and cash equivalent balances are held with various financial institutions and may at times exceed the applicable Federal Deposit Insurance Corporation limit. The Company monitors credit ratings of these financial institutions and the concentration of cash and cash equivalent balances with any one financial institution and believes the likelihood of realizing material losses from the excess of cash and cash equivalent balances over insurance limits is remote.

The following estimated fair values of financial instruments were determined by management using available market information and established valuation methodologies, including discounted cash flow. Accordingly, the estimates presented are not necessarily indicative of the amounts the Company could realize on disposition of the financial instruments. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

- Cash equivalents, rents receivable, accounts payable and accrued expenses, and other liabilities are carried at their face amounts, which reasonably approximate their fair values.
- Bond indebtedness and notes payable with an aggregate carrying value of approximately $2,301,000 and $2,350,000 had an estimated aggregate fair value of $2,426,000, and $2,541,000 at December 31, 2005 and 2004, respectively.

12. Related Party Arrangements

Unconsolidated Entities The Company manages unconsolidated real estate entities for which it receives asset management, property management, development and redevelopment fee revenue. From these entities, the Company received fees of $4,304,

$604 and $931 in the years ended December 31, 2005, 2004 and 2003 respectively. These fees are included in management, development and other fees on the accompanying Consolidated Statements of Operations and Other Comprehensive Income.

In addition, in connection with the general contractor services that the Company provided to CVP I, LLC, the entity that owns and developed Avalon Chrystie Place I, the Company has funded certain construction costs on behalf of CVP I, LLC and expects to be reimbursed through draws from escrowed bond proceeds. As of December 31, 2005 and December 31, 2004, the Company has recorded a receivable from CVP I, LLC in the amounts of $2,365 and $19,983, respectively. The Company provides similar services to Mission Bay Venture Partners, LLC, the entity that owns and is developing Avalon at Mission Bay North II. The Company has funded $6,653 in construction costs on behalf of Mission Bay Venture Partners, LLC as of December 31, 2005 and has recorded a corresponding receivable from Mission Bay Venture Partners, LLC. The Company expects to be reimbursed through draws on a construction loan. The Company is generally reimbursed for the funding of construction costs by both CVP I, LLC and Mission Bay Venture Partners, LLC within 30 to 60 days. These receivables are included in prepaid expenses and other assets on the accompanying Consolidated Balance Sheets.

Director Compensation The Company's 1994 Plan provides that directors of the Company who are also employees receive no additional compensation for their services as a director. On May 14, 2003, the Company's Board of Directors approved an amendment to the 1994 Plan pursuant to which, in lieu of the stock and option awards described above, each non-employee director would receive, following the 2004 Annual Meeting of Stockholders and each annual meeting thereafter, (i) a number of shares of restricted stock (or deferred stock awards) having a value of $100 based on the last reported sale price of the common stock on the NYSE on the fifth business day following the prior year's annual meeting and (ii) $30 cash, payable in quarterly installments of $7.5. A non-employee director may elect to receive all or a portion of such cash payment in the form of a deferred stock award. In addition, the Lead Independent Director receives an annual fee of $30 payable in equal monthly installments of $2.5. The Company recorded non-employee director compensation expense relating to the restricted stock grants, deferred stock awards and stock options in the amount of $966, $940 and $824 in the years ended December 31, 2005, 2004 and 2003 respectively. Deferred compensation relating to these restricted stock grants, deferred stock awards and stock options was $579 and $748 on December 31, 2005 and December 31, 2004, respectively. In December 31, 2005, one of the Company's directors resigned due to a disability. The Company accelerated the vesting of all outstanding equity awards at that date.

13. Quarterly Financial Information (Unaudited)

The following summary represents the quarterly results of operations for the years ended December 31, 2005 and 2004:

	For the three months ended			
	3-31-05	**6-30-05**	**9-30-05**	**12-31-05**
Total revenue	$161,245	$165,586	$170,751	$173,098
Income from continuing operations	$ 27,861	$ 25,360	$ 26,885	$ 27,564
Income from discontinued operations	$ 41,749	$ 31,551	$ 72,243	$ 69,165
Net income available to common stockholders	$ 67,435	$ 54,736	$ 96,953	$ 94,554
Net income per common share—basic	$ 0.93	$ 0.75	$ 1.32	$ 1.29
Net income per common share—diluted	$ 0.92	$ 0.74	$ 1.30	$ 1.26

	For the three months ended			
	3-31-04	6-30-04	9-30-04	12-31-04
Total revenue	$146,262	$151,393	$156,496	$159,693
Income from continuing operations	$ 15,169	$ 17,494	$ 17,374	$ 21,602
Income from discontinued operations	$ 5,561	$ 17,539	$ 27,992	$ 92,467
Net income available to common stockholders	$ 23,102	$ 32,858	$ 43,191	$111,894
Net income per common share—basic	$ 0.33	$ 0.46	$ 0.60	$ 1.55
Net income per common share—diluted	$ 0.32	$ 0.46	$ 0.60	$ 1.52

14. Subsequent Events

In January 2006, the Company sold two communities to unrelated third parties. Avalon Estates, a garden-style community located in Boston, Massachusetts, containing 162 apartment homes, was sold for a sales price of $34,450. Avalon Cupertino, a garden-style community located in San Jose, California, containing 311 apartment homes, was sold for a sales price of $88,000. The disposition of these two communities resulted in an aggregate GAAP gain of approximately $66,000. These two communities were classified as held for sale under the provisions of SFAS No. 144 as of December 31, 2005 (see Note 7, "Discontinued Operations—Real Estate Assets Sold or Held for Sale").

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of
AvalonBay Communities, Inc.:

We have audited the accompanying consolidated balance sheets of AvalonBay Communities, Inc. and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of operations and other comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. Our audits also included the financial statement schedule listed in the Index at Item 15(a)(2). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of AvalonBay Communities, Inc. and subsidiaries at December 31, 2005 and 2004, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of AvalonBay Communities, Inc.'s internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 3, 2006 expressed an unqualified opinion thereon.

McLean, Virginia
March 3, 2006

The Board of Directors and Shareholders of
AvalonBay Communities, Inc.:

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting in Item 9a., that AvalonBay Communities, Inc. maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). AvalonBay Communities, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that AvalonBay Communities, Inc. maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, AvalonBay Communities, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of AvalonBay Communities, Inc. as of December 31, 2005 and 2004, and the related consolidated statements of operations and other comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005 of AvalonBay Communities, Inc. and our report dated March 3, 2006 expressed an unqualified opinion thereon.

McLean, Virginia
March 3, 2006

MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the New York Stock Exchange (NYSE) and the Pacific Exchange (PCX) under the ticker symbol AVB. We are in the process of delisting our shares on the PCX. The following table sets forth the quarterly high and low sales prices per share of our common stock for the years 2005 and 2004, as reported by the NYSE. On January 31, 2006 there were 1,178 holders of record of an aggregate of 73,998,786 shares of our outstanding common stock. The number of holders does not include individuals or entities who beneficially own shares but whose shares are held of record by a broker or clearing agency, but does include each such broker or clearing agency as one record holder.

	2005			2004		
	Sales Price		Dividends	Sales Price		Dividends
	High	Low	declared	High	Low	declared
Quarter ended March 31	$75.59	$65.18	$0.71	$54.66	$46.72	$0.70
Quarter ended June 30	$81.80	$64.99	$0.71	$57.80	$48.30	$0.70
Quarter ended September 30	$88.23	$78.37	$0.71	$62.25	$55.89	$0.70
Quarter ended December 31	$92.99	$78.82	$0.71	$75.93	$59.90	$0.70

We expect to continue our policy of paying regular quarterly cash dividends. However, dividend distributions will be declared at the discretion of the Board of Directors and will depend on actual cash from operations, our financial condition, capital requirements, the annual distribution requirements under the REIT provisions of the Internal Revenue Code and other factors as the Board of Directors may consider relevant. The Board of Directors may modify our dividend policy from time to time. In January 2006, we announced that our Board of Directors declared a dividend on our common stock for the first quarter of 2006 of $0.78 per share, a 9.8% increase over the previous quarterly dividend of $0.71 per share. The increased dividend is payable on April 17, 2006 to all common stockholders of record as of March 31, 2006.

During the three months ended December 31, 2005, we did not issue shares of common stock in exchange for units of limited partnership held by certain limited partners.

Our Board of Directors has adopted a Stock Repurchase Program under which we may acquire, from time to time, shares of common stock in the open market with an aggregate purchase price of up to $100,000,000. No purchases were made under this program in 2005. In determining whether to repurchase shares, we consider a variety of factors, including our liquidity needs, the then current market price of our shares and the effect of the share repurchases on our per share earnings and FFO.

This Annual Report, including the Letter to Shareholders, contains certain non-GAAP financial measures and other terms. The definition and calculation of these non-GAAP financial measures and other terms may differ from the definitions and methodologies used by other REITs and, accordingly, may not be comparable. The non-GAAP financial measures referred to below should not be considered an alternative to net income as an indication of our performance. In addition, these non-GAAP financial measures do not represent cash generated from operating activities in accordance with GAAP and therefore should not be considered as an alternative measure of liquidity or as indicative of cash available to fund cash needs.

Economic Gain

The gain on sale in accordance with GAAP, less accumulated depreciation through the date of sale and any other non-cash adjustments that may be required under GAAP accounting. Management generally considers Economic Gain to be an appropriate supplemental measure to gain on sale in accordance with GAAP because it helps investors to understand the relationship between the cash proceeds from a sale and the cash invested in the sold community. The Economic Gain for each community is estimated based on the respective final settlement statement. A reconciliation of Economic Gain to gain on sale in accordance with GAAP is as follows:

	For the Year Ended				
(dollars in thousands)	**12-31-05**	12-31-04	12-31-03	12-31-02	12-31-01
GAAP Gain[1]	$199,766	$122,425	$184,438	$ 48,893	$ 62,852
Accumulated depreciation and other	(14,928)	(19,320)	(52,613)	(7,462)	(21,623)
Economic Gain	$184,838	$103,105	$131,825	$ 41,431	$ 41,229

[1] 2005 GAAP Gain includes $2,819 related to the sale of an office building and $4,479 related to the sale of three land parcels. 2004 GAAP Gain includes $1,138 related to the sale of a land parcel. 2003 GAAP Gain includes $23,448 related to the sale of a community in which the Company held a 50% membership interest and $1,234 related to the sale of a land parcel.

Estimated Net Asset Value (NAV) Per Share

The estimated market value of a company's assets less the estimated market value of all current and long-term liabilities divided by the number of outstanding common shares and operating partnership units.

Fixed Charge Coverage (Interest Coverage)

EBITDA from continuing operations divided by the sum of interest expense, net, and preferred dividends. Fixed Charge Coverage is presented by the Company because it provides rating agencies and investors an additional means of comparing our liquidity to that of other companies. EBITDA is defined by the Company as net income before interest income and expense, income taxes, depreciation and amortization. Under this definition, which complies with the rules and regulations of the Securities and Exchange Commission, EBITDA includes gains on sale of assets and gains on sale of partnership interests. A reconciliation of EBITDA and a calculation of Fixed Charge Coverage for the quarter ended December 31, 2005 are as follows:

	For the Quarter Ended 12-31-05
Net income	$ 96,729
Interest expense, net	31,076
Depreciation expense	41,341
Depreciation expense (discontinued operations)	217
EBITDA	$169,363
EBITDA from continuing operations	$ 99,981
EBITDA from discontinued operations	69,382
EBITDA	$169,363
EBITDA from continuing operations	$ 99,981
Interest expense, net	$ 31,076
Dividends attributable to preferred stock	2,175
Interest charges	$ 33,251
Interest coverage	3.0

Funds from Operations (FFO)

FFO is determined based on a definition adopted by the Board of Governors of NAREIT. See the section titled “Selected Financial Data” contained herein on page 17 for a definition and discussion of FFO. A reconciliation of FFO to Net Income is included below.

	For the Year Ended										
(dollars in thousands)	**12-31-05**	12-31-04	12-31-03	12-31-02	12-31-01	12-31-00	12-31-99	12-31-98	12-31-97	12-31-96	12-31-95
Net income	$ 322,378	$ 219,745	$ 271,525	$ 173,618	$ 248,997	$ 210,604	$ 172,276	$ 123,535	$ 64,916	$ 51,651	$ 30,937
Dividends attributable to preferred stock	(8,700)	(8,700)	(10,744)	(17,896)	(40,035)	(39,779)	(39,779)	(28,132)	(19,656)	(10,422)	—
Depreciation—real estate assets, including discontinued operations and joint venture adjustments	162,019	157,988	128,278	142,980	128,086	120,208	108,679	76,339	27,759	18,887	14,784
Minority interest expense, including discontinued operations	1,363	3,048	1,263	1,601	1,559	1,759	1,975	1,770	—	—	—
Cumulative effect of change in accounting principle	—	(4,547)	—	—	—	—	—	—	—	—	—
Gain on sale of previously depreciated real estate assets	(195,287)	(121,287)	(159,756)	(48,893)	(62,852)	(40,779)	(47,093)	(25,270)	(677)	(7,850)	—
Funds from Operations attributable to common stockholders	$ 281,773	$ 246,247	$ 230,566	$ 251,410	$ 275,755	$ 252,013	$ 196,058	$ 148,242	$ 72,342	$ 52,266	$ 45,721
Weighted average common shares outstanding—diluted	74,759,318	73,354,956	70,203,467	70,674,211	69,781,719	68,140,998	66,110,664	51,771,247	28,431,823	23,691,447	21,828,020
EPS—diluted	$ 4.21	$ 2.92	$ 3.73	$ 2.23	$ 3.02	$ 2.53	$ 2.03	$ 1.88	$ 1.59	$ 1.74	$ 1.42
FFO per common share—diluted	$ 3.77	$ 3.36	$ 3.28	$ 3.55	$ 3.95	$ 3.70	$ 2.97	$ 2.86	$ 2.54	$ 2.21	$ 2.09

Initial Year Market Capitalization Rate (Cap Rate)

Projected NOI of a single community for the first twelve months of operations following the date of the buyer’s valuation, less estimates for non-routine allowance of approximately $200–$300 per apartment home, divided by the gross sales price for the community. For this purpose, Management’s projection of stabilized operating expenses for the community includes a management fee of approximately 3.0%–3.5%. The Cap Rate, which may be determined in a different manner by others, is a measure frequently used in the real estate industry when determining the appropriate purchase price for a property or estimating the value for the property. Buyers may assign different Cap Rates to different communities when determining the appropriate value because they (i) may project different rates of change in operating expenses, including capital expenditure estimates and (ii) may project different rates of change in future rental revenue due to different estimates for changes in rent and occupancy levels. The weighted average Cap Rate is weighted based on the gross sales price of each community.

Leverage

Leverage is calculated by the Company as total debt as a percentage of Total Market Capitalization. Total Market Capitalization represents the aggregate of the market value of the Company’s common equity (defined as the sum of the market value of the Company’s common stock and the market value of the Company’s operating partnership units outstanding based on the market value of the Company’s common stock), the liquidation preference of the Company’s preferred stock and the outstanding principal balance of the Company’s fixed and variable debt. Management believes that Leverage can be one useful measure of a real estate operating company’s long-term liquidity and balance sheet strength, because it shows an approximate relationship between a company’s total debt and the current total market value of its assets

based on the current price at which the company's common stock trades. Changes in Leverage also can influence changes in per share results. A calculation of Leverage as of December 31, 2005 is as follows:

(dollars in thousands)	**12-31-05**	As a Percentage of Total Market Capitalization
Common equity	$6,612,275	73%
Preferred equity	100,000	1%
Fixed debt	2,058,869	23%
Variable debt	308,513	3%
Total Market Capitalization	$9,079,657	100%

Because Leverage changes with fluctuations in the Company's stock price, which occurs regularly, the Company's Leverage may change even when the Company's earnings, interest and debt levels remain stable. Investors should also note that the net realizable value of the Company's assets in liquidation is not easily determined and may differ substantially from the Company's Total Market Capitalization.

Mulifamily Sector Average

The Multifamily Sector Average is a weighted average based on Total Enterprise Value per Bloomberg. The weighted average for Total Shareholder Return, FFO per Share Growth, and Common Dividend per Share Growth includes AEC, AIV, ASN, BRE, CPT, EQR, ESS, HME, MAA, PPS and UDR. The 10-year weighted average for EPS Growth excludes companies with negative EPS in 2005 and companies for which there is insufficient data for 1995. The weighted average for Estimated NAV per Share Growth includes all companies under Green Street Advisors, Inc.'s coverage for which data is available during each of the time periods presented.

Net Operating Income (NOI)

Total property revenue less direct property operating expenses (including property taxes), and excluding corporate-level income (including management, development and other fees), corporate-level property management and other indirect operating expenses, investments and investment management, net interest expense, general and administrative expense, joint venture income, minority interest and venture partner interest in profit-sharing, depreciation expense, gain on sale of real estate assets, cumulative effect of change in accounting principle and income from discontinued operations. The Company considers NOI to be an appropriate supplemental measure to Net Income of operating performance of a community or communities because it helps both investors and Management to understand the core operations of a community or communities prior to the allocation of any corporate-level property management overhead or general and administrative costs. This is more reflective of the operating performance of a community, and allows for an easier comparison of the operating performance of single assets or groups of assets. In addition, because prospective buyers of real estate have different overhead structures, with varying marginal impact to overhead by acquiring real estate, NOI is considered by many in the real estate industry to be a useful measure for determining the value of a real estate asset or groups of assets. For further discussion and a reconciliation of NOI to Net Income see "Results of Operations" within "Management's Discussion and Analysis of Financial Condition and Results of Operations" contained herein on page 23.

NOI as reported by the Company does not include the operating results from discontinued operations (i.e., assets sold or held for sale as of December 31, 2005). A reconciliation of NOI from communities sold or held for sale to Net Income for these communities is as follows:

	For the Year Ended	
(dollars in thousands)	**13-31-05**	12-31-04
Income from discontinued operations	$14,942	$21,134
Interest expense, net	—	525
Minority interest expense	—	37
Depreciation expense	3,241	10,676
NOI from discontinued operations	$18,183	$32,372
NOI from assets sold	$ 9,501	$23,978
NOI from assets held for sale	8,682	8,394
NOI from discontinued operations	$18,183	$32,372

Same Store (Established) Communities

Communities that are consolidated for financial reporting purposes and where a comparison of operating results from the prior year to the current year is meaningful, as these communities were owned and had Stabilized Operations, as defined below, as of the beginning of the prior year. Therefore, for 2005, Same Store Communities were consolidated communities that had Stabilized Operations as of January 1, 2004. Same Store Communities do not include communities that are held for sale or planned for disposition or redevelopment during the current year.

Stabilized Operations

The earlier of (i) attainment of 95% physical occupancy or (ii) the one-year anniversary of completion of development.

Total Capital Cost

All capitalized costs projected to be or actually incurred to develop the respective development community or development right, including land acquisition costs, construction costs, real estate taxes, capitalized interest and loan fees, permits, professional fees, allocated development overhead and other regulatory fees, all as determined in accordance with GAAP. With respect to communities where development has been completed, Total Capital Cost reflects the actual cost incurred, plus any contingency estimate made by Management.

Unleveraged IRR

The internal rate of return calculated by the Company considering the timing and amounts of (i) total revenue during the period owned by the Company and (ii) the gross sales price net of selling costs, offset by (iii) the undepreciated capital cost of the communities at the time of sale and (iv) total direct operating expenses during the period owned by the Company. Each of the items (i), (ii), (iii) and (iv) is calculated in accordance with GAAP.

The calculation of Unleveraged IRR does not include an adjustment for the Company's general and administrative expense, interest expense, or corporate-level property management and other indirect operating expenses. Therefore, Unleveraged IRR is not a substitute for Net Income as a measure of our performance. Management believes that the Unleveraged IRR achieved during the period a community is owned by the Company is useful because it is one indication of the gross value created by the Company's acquisition, development or redevelopment, management and sale of the community, before the impact of indirect expenses and Company overhead. The Unleveraged IRR achieved on the communities as cited in this Annual Report should not be viewed as an indication of the gross value created with respect to other communities owned by the Company, and the Company does not represent that it will achieve similar Unleveraged IRRs upon the disposition of other communities. The weighted average Unleveraged IRR for sold communities is weighted based on all cash flows over the holding period for each respective community, including net sales proceeds.

AvalonBay Corporate Information

BOARD OF DIRECTORS

Bryce Blair (4)
Chairman and CEO
AvalonBay Communities, Inc.

Bruce A. Choate (2,4)
CEO and President
Watson Land Company

John J. Healy, Jr. (3,4)
Founder and CEO
Hyde Street Holdings, Inc.

Gilbert M. Meyer (4)
Founder and President
Greenbriar Homes Communities, Inc.

Timothy J. Naughton (4)
President
AvalonBay Communities, Inc.

Lance R. Primis (1,4,5)
Managing Partner
Lance R. Primis and Partners, LLC

H. Jay Sarles (2,3)
Private Investor

Allan D. Schuster (2,4,5)
Private Investor

Amy P. Williams (2,3)
Private Investor

1 Lead Independent Director
2 Audit Committee
3 Compensation Committee
4 Investment and Finance Committee
5 Nominating and Corporate Governance

OFFICERS

Bryce Blair
Chairman and CEO

Timothy J. Naughton
President

Thomas J. Sargeant
Chief Financial Officer

Leo S. Horey
Executive Vice President
Operations

Charlene Rothkopf
Executive Vice President
Human Resources

David W. Bellman
Senior Vice President
Construction–National

Sean J. Breslin
Senior Vice President
Investments–West Coast

Jonathan B. Cox
Senior Vice President
Development–Mid-Atlantic, Midwest

Lili F. Dunn
Senior Vice President
Investments–National

Frederick S. Harris
Senior Vice President
Development–NY

Dirk V. Herrman
Senior Vice President
Chief Marketing Officer

Joanne M. Lockridge
Senior Vice President
Finance and Assistant Treasurer

William M. McLaughlin
Senior Vice President
Development–MA, RI, CT, NJ

J. Richard Morris
Senior Vice President
Construction–National

Edward M. Schulman
Senior Vice President
General Counsel and Secretary

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Sean P. Sullivan
Senior Vice President
Property Operations–Metro NY, NJ, Midwest

Bernard J. Ward
Senior Vice President
Property Operations–West Coast

Stephen W. Wilson
Senior Vice President
Development–West Coast

Shannon E. Brennan
Vice President
Property Operations–Mid-Atlantic

Alfred Brockunier III
Vice President
Construction–NY

Duane W. Carlson
Vice President
Construction–Northern CA

Darren R. Carrington
Vice President
Investments–East Coast, Midwest

Deborah A. Coombs
Vice President
Property Operations–Southern CA, Pacific Northwest

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Development–MA

Mark J. Forlenza
Vice President
Development–CT

Nathan K. Hong
Vice President
Development–Northern CA

Scott R. Kinter
Vice President
Construction–Northeast

Ronald S. Ladell
Vice President
Development–NJ

Lyn C. Lansdale
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Janice A. Miner
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Property Operations–CT, NY

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Vice President
Investment Management

Christopher L. Payne
Vice President
Development–Southern CA

Walter A. Rebenson
Vice President
Development–Midwest

Michael J. Roberts
Vice President
Development–MA

Keri A. Shea
Vice President
Controller and Treasurer

Mona R. Stahling
Vice President
Property Operations

Matthew B. Whalen
Vice President
Development–Long Island

Philip M. Wharton
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AvalonBay Corporate Information (continued)

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Form 10-K
A copy of the Company's annual report on Form 10-K as filed with the Securities and Exchange Commission may be obtained without charge by contacting Investor Relations.

CEO and CFO Certifications
In 2005, the Company's Chief Executive Officer provided to the New York Stock Exchange the Annual CEO Certification regarding the Company's compliance with the New York Stock Exchange's corporate governance listing standards. In addition, the Company's CEO and CFO filed with the Securities and Exchange Commission the certification required by Section 302 of the Sarbanes-Oxley Act of 2002 regarding the quality of the Company's public disclosures in its 2005 annual report on Form 10-K.

Stock Listings
NYSE–AVB

This Annual Report, including the Letter to Shareholders, contains "forward-looking statements" within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934. Please see our discussion titled "Forward-Looking Statements" on page 32 of this report for a discussion regarding risks associated with these statements. Non-GAAP financial measures and other terms as used in this report are defined and reconciled beginning on page 63 in the section titled "Definitions and Reconciliations of Non-GAAP Financial Measures and Other Terms."

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