

Insights

Navigating Through: FASB Proposed Accounting Standards Update - Real Estate - Investment Property Entities (Topic 973)

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Introduction

On October 21, 2011, the Financial Accounting Standards Board (“FASB” or the “Board”) issued the Proposed Accounting Standards Update (“ASU”) *Real Estate – Investment Property Entities (Topic 973)* (“ASU Topic 973”). In a related project, also on October 21, 2011, the FASB issued the proposed ASU *Financial Services-Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements*, that would amend the criteria in Accounting Standards Codification (“ASC”) Topic 946, Financial Services-Investment Companies for determining whether an entity is an investment company. The FASB advises that stakeholders consider the two exposure drafts concurrently due to the interrelated nature of the proposals.

The purpose of the proposed investment property entity (“IPE”) ASU is twofold – (1) to address the diversity in practice regarding real estate property accounting and reporting by real estate entities such as real estate investment funds and (2) to align the scope of entities that would apply the proposed lessor accounting model under U.S. Generally Accepted Accounting Principles (“U.S. GAAP”) and International Financial Reporting Standards (“IFRS”). Currently, diversity in practice exists for accounting for real estate investments including historical cost based accounting, fair value accounting, or consolidation methods, and other comprehensive bases of accounting, such as cash or tax basis. Some real estate entities are already accounting for their real estate investments at fair value because:

1. Entities have been classified as investment companies under ASC Topic 946.
2. Entities are controlled by pension plans that are required to report their investments at fair value.
3. The development of industry accounting practices allows them to measure real estate investments at fair value without regard to investment company attributes or pension plan ownership.

However, under the proposed ASU Topic 973, all entities that meet the requirements of an IPE would be required to report their real estate investments at fair value. This would increase the comparability of financial statements and establish consistency in applying fair value measurement of investment property entities.

In aligning the scope of entities that would apply the proposed lessor accounting model under U.S. GAAP and IFRS, as part of the FASB and International Accounting Standard Board’s (“IASB”) joint project on accounting for leases, the IASB decided, that “a lessor of an investment property would not be required to apply the proposed lessor accounting requirements per the IASB’s August 2010 Exposure Draft (“ED”) on leases, if the lessor measures its investment properties at fair value by electing the fair value model under International Accounting Standards 40, *Investment Property*.” Currently U.S. GAAP do not provide a basis for excluding investment properties from the proposed lessor accounting. With the implementation of the proposed amendments to ASU Topic 973, this exclusion would exist.

Who Will Be Affected?

It is expected that the proposed amendments would significantly change accounting and reporting by many real estate entities. The proposed guidance would affect any entity in which substantially all of its business activities are investing in real estate property or properties for total return, including an objective to realize capital appreciation. An entity that invests in real estate properties but does not qualify as an IPE may fall under the scope of proposed ASU, *Financial Services-Investment Companies (Topic 946)* or original ASC Topic 946. An entity should first evaluate the criteria to determine if it qualifies as an IPE and if the criteria are met, then the IPE guidance would apply. If an entity does not qualify as an IPE, then the entity should review the investment company criteria under ASC Topic 946. If an entity does not fall under either ASC Topic 973 or 946, its real estate investments may need to be accounted for at historical cost, under other U.S. GAAP.

In the proposed ASU *Financial Services-Investment Companies (Topic 946)*, the Board decided to remove the scope exception in paragraph 946-10-15-3 for real estate investment trusts. The proposed ASU *Financial Services-Investment Companies (Topic 946)*, states that this decision was based on the premise that the scope exception is based on whether an entity has made a designation to be treated as a real estate investment trust under the Internal Revenue Service (“IRS”) tax code. The Board concluded that an entity’s election as a real estate investment trust (“REIT”) for tax purposes should not affect whether the entity is an investment company, rather the nature of the entity’s activities and operations should dictate its basis of accounting. It is important to note that under the proposed amendments to both ASU Topic 973 and ASU Topic 946, there are no limitations on REITs being either an IPE or an investment company.

The proposed amendments to ASU Topic 973 would not apply to an entity whose purpose, upon completion of development, is to use real estate holdings for its own use in the production or supply of goods, services, for its administrative purposes, or for sales in the ordinary course of business. In addition, if a parent entity that would otherwise be considered an IPE has a substantial investment in any of these types of entities, the parent could potentially be excluded from being classified as an IPE. Therefore, an entity would need to carefully evaluate its investment strategy to determine whether it falls under the scope of ASU Topic 973, ASU Topic 946 or neither.

When Does an Entity Qualify as an IPE?

An entity that meets all of the following criteria qualifies as an IPE.

1. *Nature of the business activities*

Substantially all of the entity’s business activities are investing in real estate properties. The entity should not hold significant assets or liabilities other than those relating to its investments in real estate properties. However, if an entity provides or holds an investment in an entity which provides services that relate only to the IPE’s own investment activities, even if those activities are significant, the entity can still meet the nature-of-the-business-activities criterion to qualify as an IPE. An IPE can hold investments in other assets as long as the investments are not significant to the entity. When assessing this criterion, investments in mortgage receivables and mortgage-backed securities are not considered investments in real estate properties. The Board did not define what is meant by “substantially all”, but it is presumed to be an extremely high threshold. Judgment will need to be exercised when evaluating this criterion.

2. *Express business purpose*

The express business purpose of the entity is to invest in real estate properties for total return including an objective to realize capital appreciation (through disposal of its real estate properties, for example). Such a business purpose should ordinarily include an exit strategy for an entity to dispose of its properties to realize capital appreciation to maximize total returns. Disposal of real estate properties only during liquidation or to satisfy investor redemptions is not considered an exit strategy. Although the IPE may not yet have determined the specific method or timing of disposing its investment properties, the fact that the entity has developed strategies through which it would realize appreciation to maximize total returns, provides evidence that its business purpose is consistent with the express business purpose of an IPE. Therefore, an entity that markets itself to investors as having a business purpose which focuses on the development of real estate properties for sale or an entity that holds real estate investments for its own use will not qualify as an IPE. The proposed ASU Topic 973 states that “evidence of the entity’s express-business-purpose may be included in the entity’s offering memorandum, publications distributed by the entity and other corporate or partnership documents that indicate the investment objectives of the entity. Evidence of the entity’s express business purpose also may include the manner in which the entity presents itself to other parties (such as potential investors

or potential investees). For example, an entity that presents its business to its investors as having the objective of investing in real estate properties for capital appreciation has an express business purpose that is consistent with the express business purpose of an IPE. Alternatively, an entity that presents itself as being in the business of developing real estate properties for sale upon completion (such as a land developer or home builder) has an express business purpose that is inconsistent with the business purpose of an IPE.”

An entity may meet the express-business-purpose criterion indirectly through a controlling financial interest if the subsidiary meets the nature-of-the-business-activities and express-business-purpose criteria.

3. *Unit ownership*

To be considered as an IPE, investors are required to acquire ownership units in the form of equity or partnership interests. Each unit of ownership represents a specifically identifiable portion of the net assets of the IPE rather than interests in specified assets. This criterion helps to ensure that an IPE has investors who enter and exit their investments in an IPE and rely on the fair value of the entity’s investment properties to make their investment decisions.

4. *Pooling of funds*

The funds of the entity’s investors are pooled to avail the investors of professional investment management. An IPE should have one or more investors that are not related to the entity’s parent (if applicable). In total, these investors must hold significant ownership interests. Investors related to the parent would be considered as a single investor when evaluating this criterion. The focus of this criterion is on the number and nature of investors and the significance of the unrelated investments. The Board did not provide guidance on how “significant” should be interpreted; therefore judgment will need to be exercised.

5. *Reporting entity*

The entity provides financial results about its investing activities to its investors. The entity can be, but is not required to be, a legal entity. The economic substance of the entity, rather than its legal form, will need to be evaluated to determine whether or not the entity is a reporting entity that provides investors with periodic financial results of the performance of real estate investments.

It is important to note that the proposed ASU Topic 973 provides an exemption from the unit ownership and pooling of funds criteria for a subsidiary whose parent is required to account for its investments at fair value (for example, a pension fund) or whose parent is a not-for-profit entity (under ASC Topic 958 - Not-for-Profit Entities) that measures its investments at fair value. However, such subsidiaries may qualify for IPE accounting if they meet the other three criteria. The proposed *Financial Services-Investment Companies ASU (Topic 946)* did not provide a similar scope exception.

Measurement of an Investment Property

The proposed ASU Topic 973 would require an IPE to initially measure its investment properties at transaction price, including transaction costs. This amendment will align the initial measurement guidance in IAS 40 and ASC Topic 946 for investment companies. The proposed ASU Topic 973 would require an IPE to subsequently measure its investment properties at fair value with all changes in fair value recognized in net income. Real estate properties other than investment properties held by an IPE would be measured in accordance with other relevant U.S. GAAP. The proposed ASU Topic 973 would also require an IPE to measure its financial liabilities (such as its own debt) in accordance with other U.S. GAAP.

Use of the Net Asset Value Practical Expedient

The Board decided to permit an investor in an IPE to use the net asset value practical expedient in ASC Topic 820 on fair value measurements to estimate the fair value of its investments if the investor would transact at net asset value per share.

Changes in Presentation and Disclosure

Under the proposed ASU Topic 973, to enhance the understanding of the nature, risks and benefits of IPEs, an IPE will be required to separately present the rental revenue, rental operating expenses, fair value of investment properties, and any associated debt in its financial statements. Rental revenue from an investment property subject to a lease should be recognized in accordance with the contractual terms of that lease. Any increases and decreases in rent including concessions, rent escalations, and free rents would not be recognized (i.e., no straight-lining of rent) because the fair value of an investment property would include the effects of the future rent changes. An IPE must also present separately the amount of realized and unrealized gains or losses on assets and liabilities measured at fair value with all changes in fair value recognized in net income.

Currently under ASC Topic 805 Business Combinations, the acquisition date fair value of a property subject to an operating lease is calculated separately from the lease contract. Meaning, the fair value of the asset is the same regardless of whether it is subject to a lease contract. The acquirer of an investment property in a business combination separately recognizes an asset or a liability if the terms of the lease are favorable or unfavorable to market terms. However, under the proposed ASU Topic 973, acquired investment properties are exempt from this requirement to avoid a potential conflict between initially measuring the property excluding the lease contract and subsequently measuring the property considering the lease contract. An IPE would be required to follow all other guidance in ASC Topic 805 relating to business combinations.

An entity that was previously considered an investment company under ASC Topic 946, and reported as such, may need to revise its financial statement presentation if it meets the criteria to be an IPE under proposed ASU Topic 973. In addition, a parent entity that is considered an investment company under ASC Topic 946 is not required to consolidate subsidiaries that invest substantially in real estate. However, under the proposed ASU Topic 973, a parent of an IPE is required to consolidate that IPE. The proposed ASU Topic 973 would require an IPE to consolidate the following entities in accordance with ASC Topic 810 Consolidation, if it has a controlling financial interest in those entities:

1. Another IPE
2. An investment company as defined in ASC Topic 946
3. An operating entity that provides services to the IPE

The proposed ASU Topic 973 states that an IPE would not consolidate other controlling financial interests. An IPE would measure a controlling financial interest in any other entity at fair value with all changes in fair value recognized in net income. The proposed ASU Topic 973 also states that an IPE would apply the equity method of accounting only for an investment in an operating entity that provides services to the IPE. The proposed ASU Topic 973 states that an IPE would be required to measure all other investments that would otherwise qualify for the equity method of accounting at fair value with all changes in fair value recognized in net income.

The proposed ASU Topic 973 also requires IPEs to disclose the following information:

1. Amounts recognized in net income for direct operating expenses, separately for investment properties that generate rental revenue during the reporting period, and investment properties that did not generate rental revenue during the period;
2. Any restrictions on the IPE's ability to increase rent, collect rental revenue, or collect proceeds on the sale of an investment property;
3. Any contractual obligations related to an investment property;
4. An entity with a change in status shall disclose the fact that a change in status occurred as well as the reasons for that change; and
5. An entity not previously an IPE under ASC Topic 973 and that becomes an IPE under ASC Topic 973 shall disclose the effect of the change in status on the reported amounts of investment properties as of the date of the change in status.

The proposed ASU Topic 973 does not have a requirement to present financial highlights. This may represent a change for many investors in real estate funds that are accustomed to receiving financial highlights as part of the typical financial statement presentation.

Effective Date and Transition

The FASB will determine an effective date after its consideration of feedback received from constituents through the comment letter process on the proposed ASU Topic 973 and will also consider effective dates for the amendments in the proposed updates on investment companies and leases when determining the effective date for the amendments in the proposed ASU Topic 973.

The Board decided to require an entity to recognize the effect of adopting the proposal as a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. The Board decided not to require retrospective application due to the perceived costs involved in determining fair values for prior periods. The Board decided to prohibit early adoption because of concerns that it would reduce the comparability of financial statements among similar entities.

Next Steps

The comment period on the exposure draft for ASU Topic 973 ends on February 15, 2012. WeiserMazars LLP encourages you to review our comment letter on this proposed ASU for insight on our views on the proposed amendments. This can be found at the FASB website: www.fasb.org.

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