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NCREIF Fall Conference 2011 Accounting Technical Update

November 9, 2011



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Today's Agenda

Update on joint projects

Leases

Revenue recognition

Financial instruments

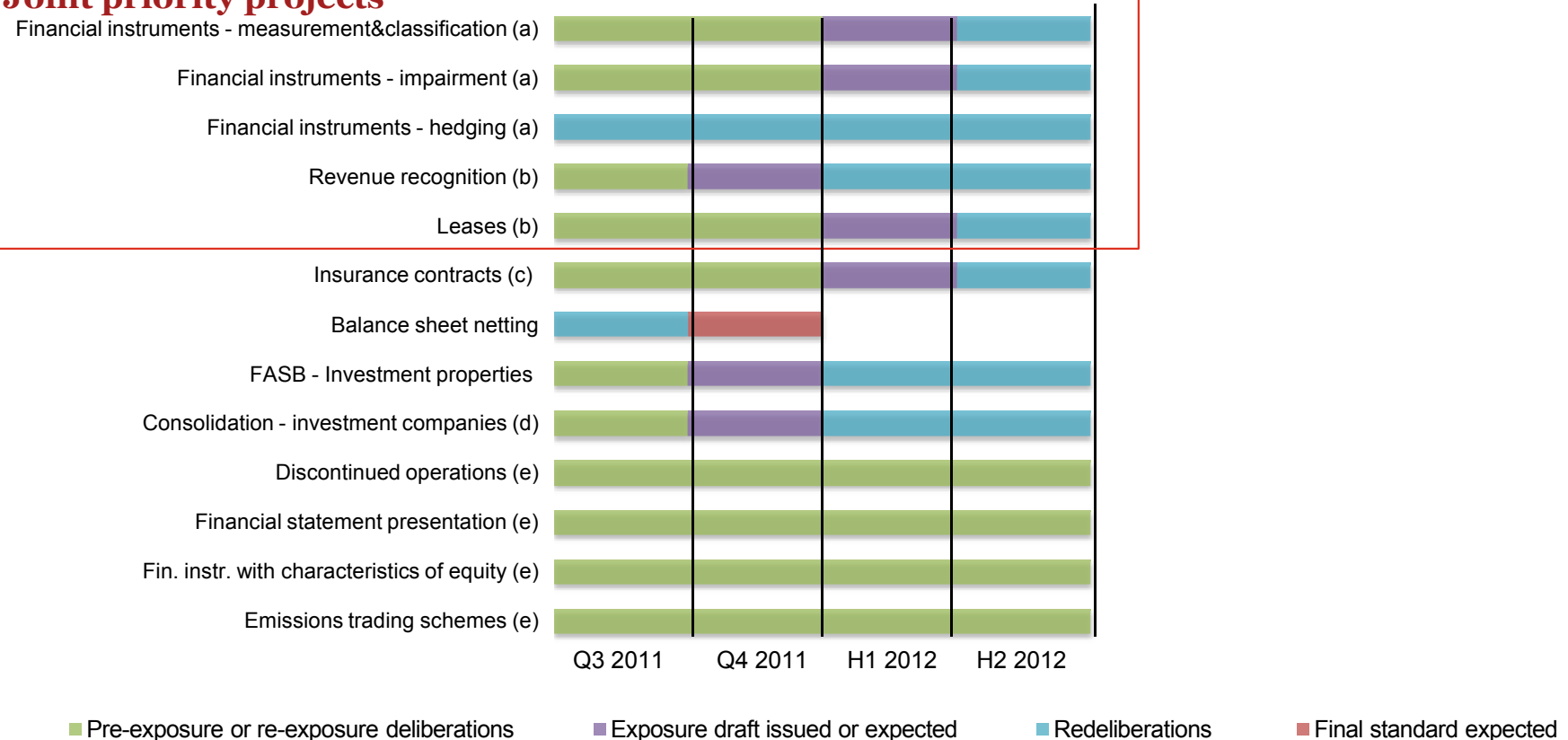
Newly issued standards and those on the horizon

Regulatory update

Updates on joint projects

FASB - The current state of convergence

Joint priority projects



- (a) Represents FASB timeline. FASB continues to re-deliberate the issues in the **measurement & classification** and **impairment** projects and will decide whether to re-expose for public comment. FASB's expected timing on **Hedge Accounting** project is later 2012. IASB has proposed delaying the effective date of its standard on classification and measurement until other phases of the project (impairment and hedge accounting) are complete.
- (b) Boards decided to re-expose **Revenue** and **Leasing**. Final standards are expected second half of 2012.
- (c) Represents FASB timeline. FASB is working with IASB to converge and improve US GAAP in the insurance contracts project. Re-exposure is expected, with a final standard possible in 2012/2013.
- (d) IASB issued its final consolidation standard in Q2 2011. The FASB has issued on November 3, 2011 an ED with limited amendments to FAS167 (ASU 2010-10). The **investment companies** ED was issued by FASB on October 21, 2011 while the IASB ED was issued in August 2011. Comments for both are due January 5, 2012.
- (e) The Board reassessed these as a lower priority projects and further action is not expected in the near term.

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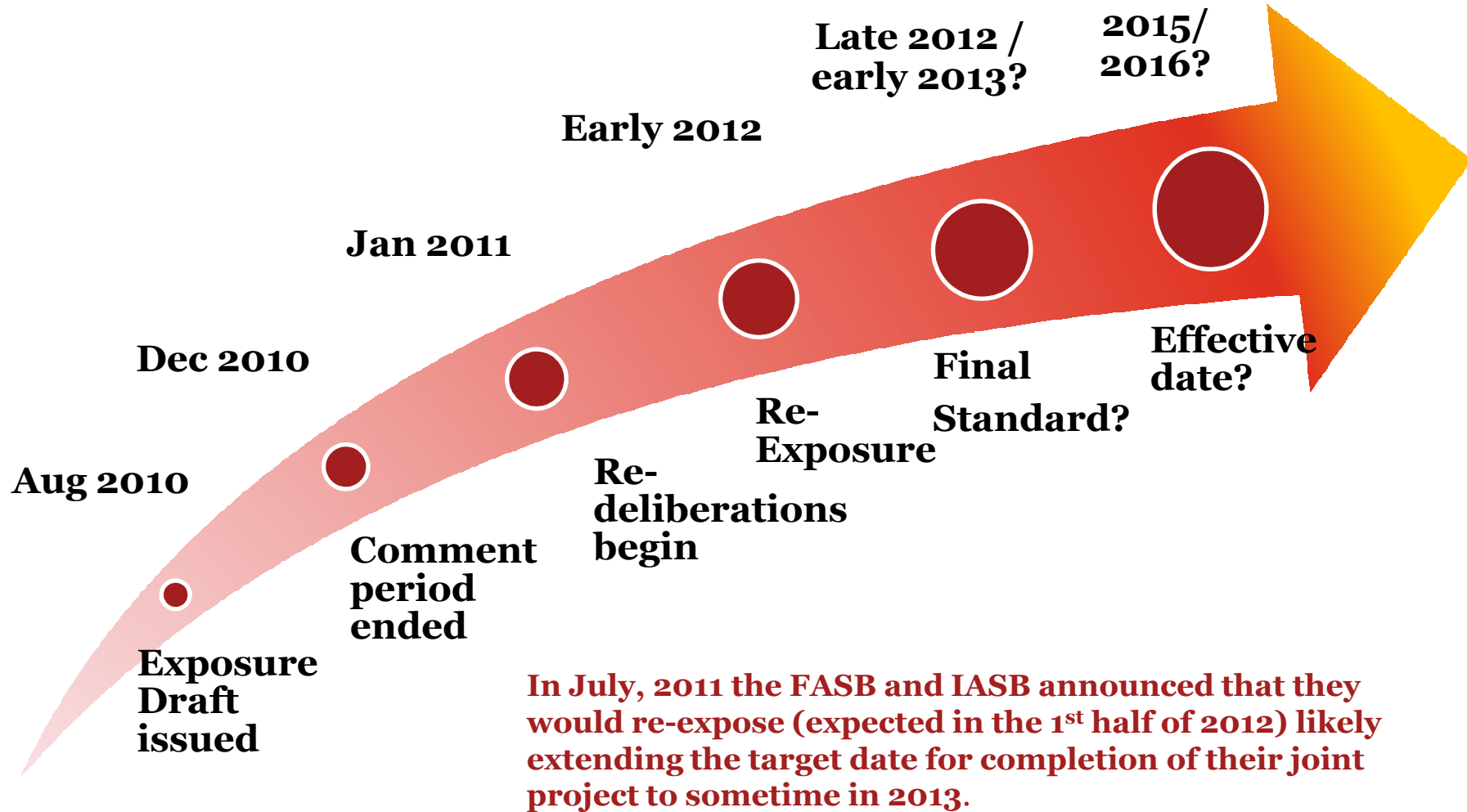
Lease accounting

Joint FASB/IASB project: Accounting for leases

Problems with existing lessee accounting rules

- Financial statements are not perceived to clearly depict impact of operating leases since lease obligations are off-balance sheet.
- Economically similar transactions can lead to significantly different accounting due to "bright lines," reducing transparency and comparability.
- Existing rules may provide opportunities to structure transactions to achieve a particular lease classification.
- Some users believe operating leases give rise to assets and liabilities that should be recognized in the financial statements of the lessee.
- The current accounting is believed to be conceptually flawed – for a simple lease, the definitions of both an asset and a liability clearly are met.

Joint FASB/IASB project: Accounting for leases (continued)



Joint FASB/IASB project: Accounting for leases (continued)

Scope

What is scoped in:

- All leases of tangible assets (property, plant and equipment) including short term leases
- Leases embedded within other arrangements such as service or supply contracts

What is scoped out:

- Transactions legally structured as leases but considered to be purchases (by lessee) and sales (by lessor) of the underlying asset
- Leases of intangible assets, biological assets (including timber), and exploration for or use of natural resources such as minerals, oil, natural gas
- Investment property accounted for at fair market value under IAS 40 or investment property entities required to measure investment property at fair market value

Joint FASB/IASB project: Accounting for leases (August 2010) (continued)

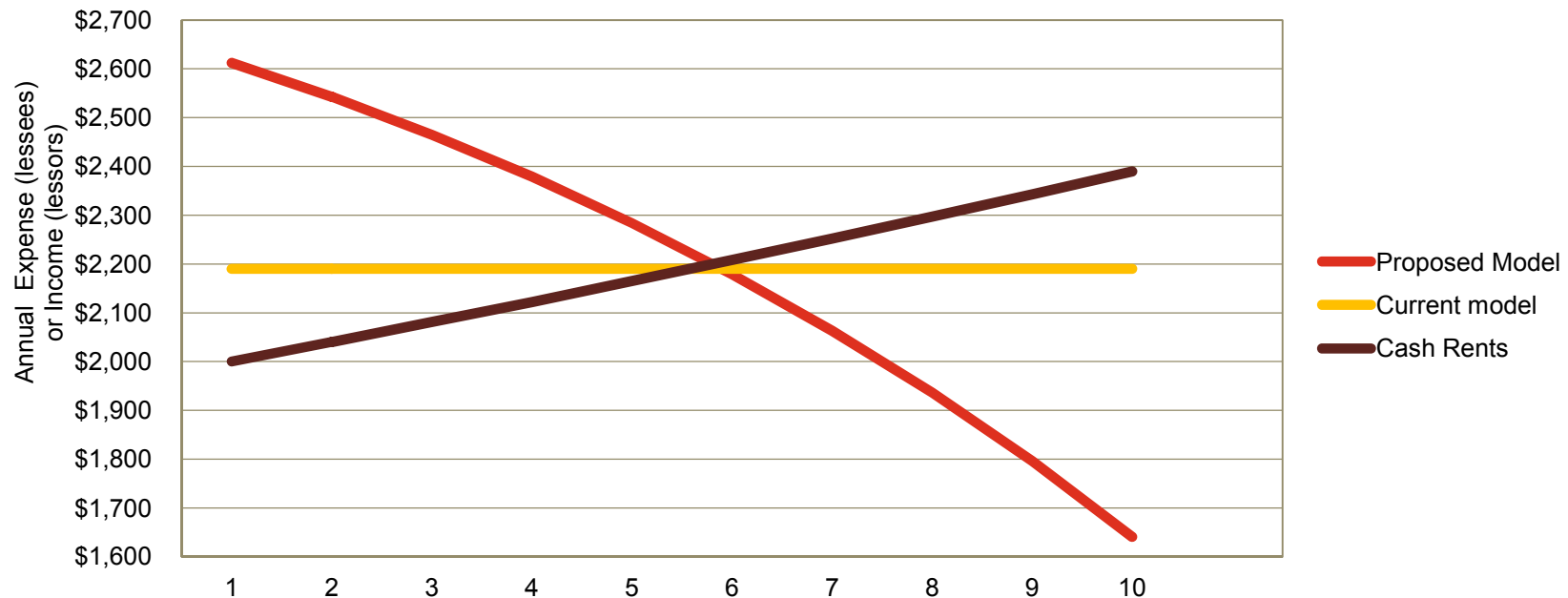
Summary of proposals in the ED

- Proposed rules will eliminate operating lease accounting by lessees:
 - Balance sheet grossed up with an asset and liability for all leases
 - P&L – geography changes; expense recognition changes with front-loading and more volatility
- Lease term, contingent rents, residual value guarantees need to be estimated and re-measured
- Broad impacts on debt covenants, real estate and equipment financing strategy (lease vs. own), models for forecasting, impacts on incentive compensation plan metrics, etc.
- Additional processes, controls and systems
- Maintain records to support estimates and periodic re-measurements
- Existing leases are not “grandfathered”

Balance sheet	
Assets	↑
Liabilities	↑
Income statement	
Rent expense	↓
Amortization	↑
Interest expense	↑
EBIT	↑
EBITDA	↑
EBITDAR	=
EPS	↕
Cash flow statement	
Cash from ops	↑
Cash from finance	↓

Joint FASB/IASB project: Accounting for leases (continued)

Impact of the proposed model on annual expense/income



The chart above depicts the impact on earnings for a basic 10-year lease with an initial annual rent of \$2,000, a 2% annual escalation rate and an assumed incremental borrowing rate of 7%. Lease expense for lessees (and lease income for lessors under the performance obligation approach) is front-end loaded.

Joint FASB/IASB project: Accounting for leases (continued)

Comment letter summary

- The Boards received nearly 800 comment letters and held public round table discussions in Hong Kong, London, Chicago and Norwalk in December and January
- Major themes of comment letters
 - Complexity
 - Operationality
 - Theory vs practical views
 - Cost/benefit
- The boards identified five key areas for discussion as follows:
 - Definition of a lease
 - Lessor accounting
 - Lease term (i.e., extension option issues)
 - Variable lease payments
 - Profit and loss recognition pattern
- The Boards also identified an additional list of issues to address

Joint FASB/IASB project: Accounting for leases (continued)

Comment Letter Highlights

Area	Summary of Comments
Scope exclusions	Revisit proposals on short-term leases and leases of intangibles.
Lessee accounting	Disagree with measurement provisions for more complex leases. Concern about the “deemed financing” premise and front-end loading of expense.
Lessor accounting	Proposed model not significant improvement and inconsistent with revenue model.
Extension options	“More-likely-than-not” is too low of a threshold, subjective and increases volatility.
Contingent payments	Suggest “best estimate” approach vs. “probability-weighted” approach.
Profit and loss recognition pattern	Many questioned the usefulness of the new model – replacing rent expense with depreciation and interest expense.
Purchase options	Purchase options should be considered as part of the lease model.
Multiple-element contracts	Concerned about embedded leases. Prefer specific exclusion of service and executory costs vs. linking to definition of distinct service.
Reassessment	Concerned about operability of this requirement.
Transition	More guidance needed for use of hindsight, sale leasebacks, leveraged and build-to-suit leases.
Disclosure	Allow judgment in determining the volume of disclosures and f/s presentation.

Re-deliberations

Preliminary decisions reached

Major area	Status of discussion/direction
Definition of a lease	<p>The boards affirmed the proposal in the ED to define a lease as “a contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration.”</p> <p>However, the boards tentatively decided to revise the guidance for distinguishing a service from a lease and also address some of the specific problems in applying current lease guidance for certain types of transactions (e.g., PPAs).</p> <p>A contract is evaluated by assessing whether it meets both of the following criteria:</p> <ul style="list-style-type: none"> • <u>Specified asset</u> – fulfillment of the contract depends on providing a specified asset(s) either explicitly or implicitly. • <u>Control</u> – the contract conveys the right to control the use of a specified asset for a period of time. <p>The boards also discussed how these criteria would be applied in evaluating contracts for a portion of a larger asset.</p>

Re-deliberations

Preliminary decisions reached (continued)

Major area	Status of discussion/direction
Definition of a lease: Portion of a larger asset	<p>The boards further agreed that a physically distinct portion of a larger asset, for example, a floor of a building, could be a specified asset.</p> <p>However, non-physically distinct portions could not be a specified asset. For example, while partial capacity of a pipeline could not be a specified asset, particular strands within a fiber-optic cable could potentially be a specified asset.</p>

Re-deliberations

Preliminary decisions reached (continued)

Major area	Status of discussion/direction
Lease Term	<p>Raise the threshold for inclusion of extension options in the lease term from the "more likely than not" threshold in the ED to those that provide "a significant economic incentive for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease." A list of indicators of economic incentive will be provided .</p> <p>Reassessment of lease term should be performed when there is a significant change in one or more of the indicators such that the lessee would then either have, or no longer have, an economic incentive to exercise an option or terminate the lease. The boards tentatively agreed that when re-assessing whether an extension option should be included in the measurement of the lease term, the lessee should consider contract based, asset based, and entity specific factors in determining whether there is a significant economic incentive to exercise the option.</p>

Re-deliberations

Preliminary decisions reached (continued)

Major area	Status of discussion/direction
Variable Payments	<p>Any contingent amounts would be included using a best estimate approach rather than the probability-weighted approach proposed in the ED.</p> <p>The boards tentatively decided that the following variable lease payments should be included in the measurement of lease obligations and assets:</p> <ul style="list-style-type: none"> • All contingencies that are based on a rate or an index • Any contingency that is a "disguised" minimum lease payment (i.e., an anti-abuse provision) • Any portion of residual value guarantees that are expected to be paid <p>Variable lease payments that are usage or performance based (e.g., tenant sales based) would not be included in measuring the lease asset and liability unless the variable lease payments are "disguised" or in-substance fixed lease payments (i.e., anti-abuse provision).</p> <p>"Term option penalties" should be included or excluded in a manner that is consistent with the thresholds for including extension options.</p>

Re-deliberations

Preliminary decisions reached (continued)

Major area	Status of discussion/direction
Variable Payments (continued)	<p>The boards revisited the accounting for variable lease payments that are based on a rate or index and agreed that such payments would initially be measured at the rate that exists at lease commencement. In practice, this means that leases with payments based on LIBOR would use a current spot rate. Leases with payments based on a CPI index would use the absolute index at lease commencement and not the expected rate of change in that index.</p> <p>For example, a lease with fixed rental increases of 2% per annum as a proxy for inflation will include such adjustments in the initial measurement, while a lease with rental increases based on changes to CPI (which may be expected to increase at the same rate of 2% per annum) will not include these expected rate changes.</p> <p>In addition, variable lease payments will require reassessment as rates and indices change. Lessees would account for this change in profit or loss when it relates to a past or current accounting period and as an adjustment to the right-of-use asset when it relates to a future period.</p>

Re-deliberations

Preliminary decisions reached (continued)

Major area	Status of discussion/direction
Profit and loss recognition	<p>The ED treats all leases as financing transactions with an accelerated profit and loss recognition pattern more commonly associated with financing transactions. Many respondents across a wide range of industries had significant concerns about this approach.</p> <p>The boards had tentatively decided that there should be a fundamental distinction between those leases that are primarily financing transactions in nature and those that are not (i.e., so called "other-than-financing" leases.) While both types of leases would be recognized on the balance sheet, the expense recognition would differ.</p> <p>The boards reversed this prior tentative decision because of both conceptual and practical application concerns. Many board members observed that most leases contain a financing element of some magnitude, which should not be ignored. Further, the boards had concerns regarding the application of a straight line expense pattern while concurrently achieving the appropriate balance sheet recognition. That is, a straight line expense approach would either require an amortization adjustment (for example, through comprehensive income) or, alternatively, a "sinking fund" type amortization approach for the right-to-use asset (which is not typically allowed for other owned assets).</p>

November 2011

Re-deliberations

Preliminary decisions reached (continued)

Major area	Status of discussion/direction
Lessor accounting	<p>Many respondents to the ED (including many in the user community) did not believe that the proposed lessor model in the ED was a sufficient improvement to warrant the substantial additional costs to implement and apply the new proposals.</p> <p>In July 2011, the boards agreed that lessors should account for leases using a "receivable and residual" approach (previously called the "derecognition" approach). Under this approach, a lessor would derecognize the underlying asset and record a lease receivable and residual asset. The lessor would allocate the carrying value of the underlying asset being leased between the portion related to the lessee's right-of-use asset and the portion retained by the lessor (the residual).</p> <p>The approach allows for a lessor to recognize profit on the leased asset at lease commencement for the difference between the lease receivable recognized and the portion of the carrying amount of the underlying asset derecognized. Any profit related to the residual asset would be deferred throughout the lease term and is only recognized in income at the end of the lease term – either upon the sale or re-lease of the underlying asset.</p>

Important Decisions from the October 19, 2011 Joint Board Meeting

- The Boards upheld their decision to maintain the receivable and residual approach for lessor accounting (with some modifications from the original model presented at the July 2011 meeting)
- A surprise tentative decision was reached to provide a scope out to lessors of investment property (whether or not that investment property is measured at fair value or historical cost)
- Upheld previous decisions to allow a scope out for lessors of short term leases (with a maximum term of 1 year or less)
- Uncertainly around whether or not the FASB will re-visit a dual model for lessees (to address potential concerns for lessees of investment property given the decision to provide a scope out for lessors)
 - FASB voted 4 to 3 to re-visit lessee accounting for lessees of investment property
 - IASB voted 13 to 2 against re-visiting lessee accounting.

Joint FASB/IASB project: Accounting for leases (continued)

Other tentative decisions

- **Short-term leases:** A tentative decision was made that short term leases (those leases with a maximum possible lease term of 12 months or less, including all renewal periods) will continue to be treated as an operating lease, if elected. Accounting policy election made on an asset class basis.
- **Separating lease and non-lease components:** lessees will allocate payments based on relative standalone purchase price. Lessors will allocate based on allocation method in the revenue recognition project
- **Measurement of the asset and liability** will be at the commencement date (i.e., the date the lessor makes the leased asset available to the lessee) of the lease rather than the inception date as proposed in the ED
- **Discount rate** will be implicit rate, if known, otherwise incremental borrowing rate. For lessors discount rate will be borrowing rate, implicit rate, or the yield on the property for property leases. The discount rate will be reassessed when there is a change in lease payments due to the assessment of options or exercise of an option such that it changes the lease term.

Joint FASB/IASB project: Accounting for leases (continued)

Other tentative decisions

- **Lease incentives** will be accounted for based on the nature of the incentive. For lessees, incentives that meet the definition of initial direct costs will be deducted from the initial measurement of the right-of-use asset. Any other upfront cash payment is considered to relate to the right-of-use asset and would be netted against total lease payments when calculating the lease liability at commencement date. For lessors, amounts paid to lessees that meet the definition of initial direct costs would be accounted for as such and capitalized on the balance sheet. Other upfront payments to the lessee would either reduce the profit recognized by the lessor at the commencement date, if applying the derecognition approach or reduce the lease liability if the performance obligation approach is applied

Joint FASB/IASB project: Accounting for leases (continued)

Other tentative decisions

- **In substance sales and purchases** the standard will not include guidance for distinguishing a lease of an underlying asset from an in-substance purchase or sale of that asset. Instead, the leasing standard will focus on the definition of a lease. Where the lease definition is not met, the contract should be accounted for in accordance with other applicable standards, such as revenue recognition by lessors and property, plant and equipment by lessees.
- **Purchase options** will be included in measurement of the right to use asset and liability if there is a significant incentive to exercise the option.
- **Sale leaseback** Gain recognized immediately if a sale has occurred. Sale will require surrender of control (as determined in the revenue recognition project).
- **Embedded derivatives in lease contracts** an entity should assess whether a lease contract includes embedded derivatives that should be bifurcated and accounted for in accordance with applicable guidance on derivatives.

Joint FASB/IASB project: Accounting for leases (August 2010) (continued)

Reactions

- JP Morgan – “Bringing operating leases onto the balance sheet and changing the measurement basis of all leases has the potential to affect significantly the ratios and related quantities commonly used in investment decision making.” (October 2010)
- PwC – “Lease accounting for retailers – the biggest ever accounting change?” (2010 publication title)
- Credit Suisse – “\$634 billion in future minimum lease payments due under operating leases by the companies in the S&P 500” (August 2010)
- Standard & Poors – “Proposed lease-accounting requirements likely to affect our analysis” (November 2010)

Impacts by industry

- PwC assessed the impact of the leasing proposals on the financial statements and key financial ratios of a sample of approximately 3,000 listed companies across a range of industries worldwide.

Industries	Average percentage** increase		
	Leverage **	Interest-bearing debt	EBITDA *
Retail and trade	64	213	55
Other services	34	51	25
Transportation and warehousing	31	95	44
Telecommunications	20	23	16
Professional services	19	158	27
Amusement	19	25	13
Accommodation	18	101	30
Wholesale trade	17	34	21
Manufacturing	9	50	13
Construction	8	68	14
Oil, gas, and mining	7	30	10
Financial services	6	27	15
Utilities	2	3	6
All companies	13	58	18

* Earnings Before Interest, Taxes, Depreciation and Amortization

** Increase in leverage (calculated as interest-bearing debt divided by equity) is the average increase in percentage points

Source: PwC, *Proposed lease accounting: research of impact on companies*, research conducted with the Rotterdam School of Management, 2009.

Varying Impact on Different Property Sectors

Relative likely impact on property sectors

Asset Class/subclasses	Tenant Potential Impact	Sector Impact	Notes
Regional malls	Higher	Very High	Anchors long leases, higher concentration
Hospital Net lease	Higher	Very High	Large complex leases, higher concentrations
Central Business District offices	Higher	High	Large complex leases, some concentrations
Single tenant properties Long term Triple-net	Higher	High	Large complex leases, some concentrations
Retail strip centers	Moderate	Moderate	Anchors long leases, some concentration
Industrial	Moderate	Low	Shorter lease terms, limited concentrations
Suburban offices	Moderate	Low	Shorter lease terms, limited concentrations
Residential apartments	Low	Low	Short lease, no concentration
Hotels	Very Low	Very Low	Very short terms, no concentration

Revenue recognition

Joint FASB/IASB Revenue recognition project

Objective: Develop a single, comprehensive revenue recognition model

- The new revenue recognition model is a single, contract-based, asset and liability model.
- Replaces all existing U.S. GAAP and IFRS revenue recognition literature
 - Applies to contracts with customers across all industries.
 - Scope exceptions include: leases, insurance, financial instruments, certain guarantee contracts and certain nonmonetary exchanges.
- Exposure draft released in June 2010 and comment letter period ended on October 22, 2010 (over 950 submitted).
- Re-exposure expected in Q4 2011 with a 120-day comment period.
- Issuance of final standard is expected late 2012 or early 2013.
- Effective date for adoption would be no earlier than January 1, 2015

Proposed model

Identify the contract(s) with the customer

Identify and separate performance obligations in the contract(s)

Determine the transaction price

Allocate the transaction price (on a relative stand-alone selling price basis)

Recognize revenue when a performance obligation is satisfied

Proposed model

Single contract-based asset/liability model

- Contract is agreement between two or more parties that creates enforceable rights and obligations
 - Written or verbal (based on customary practice)
- Customer is a party that has contracted to obtain an output of the Company's ordinary activities

Identify the contract(s) with the customer

- Generally applied to a single contract with a customer
- Combine two or more contracts when they are entered into at or near the same time, and:
 - Negotiated with a single commercial objective
 - Consideration in one contract depends on the other
 - Goods and services are interrelated
- Contract modifications are a separate contract if:
 - Results in the addition of a separate performance obligation, and
 - Price is commensurate with that additional performance obligation

Proposed model

Identify and separate performance obligations

- Obligations are promises to transfer goods or services to a customer,
- Includes implicit obligations
- Account for goods or services as one performance obligation if the risks in providing the goods and services are largely inseparable
- Account for goods or services as a separate performance obligation **if:**
 - Entity regularly sells the goods or services separately, or
 - Customer can get benefit on its own from the good or service, or with resources readily available
- Practical expedient for goods or services delivered over the same period of time

Proposed model

Determine the transaction price

- The amount of consideration that an entity is entitled to under the contract, whichever is more predictive
 - Probability-weighted amount, or
 - Most likely outcome amount
- Transaction price includes:
 - **Variable consideration**
 - **Time value of money** (when contract included a significant financing component)
 - **Consideration payable to the customer** (similar to today)
 - **Non cash consideration** measured at fair value
- **Collectibility** not included
 - Not a hurdle to recognition
 - Initial assessment of credit risk and subsequent adjustments recorded as contra revenue

Proposed model

Allocate the transaction price

- Relative standalone selling prices
 - Estimated standalone selling prices if no actual standalone sales
 - Residual value
 - May be used as a technique to estimate if standalone selling price if highly variable or uncertain
- Portions of the consideration can be allocated to one or more performance obligations, if certain criteria are met
- Continuously update transaction price estimate over life of the contract

Proposed model

Recognize revenue when a performance obligation is satisfied

- Amount of revenue to which the entity is entitled must be **‘reasonably assured’**
- Circumstances when the amount of revenue to which the entity is entitled would not be ‘reasonably assured’ include:
 - the entity has no experience with similar contracts
 - the entity has experience but the experience is not predictive
 - Sales based royalty type arrangements for intellectual property licenses

Proposed model

Recognize revenue when a performance obligation is satisfied - **Goods**

- Goods - revenue recognized when the customer obtains control of the good.
- Indicators of control transfer of good include:
 - Customer has unconditional obligation to pay
 - Customer has legal title
 - Customer has physical possession
 - Customer has risk and rewards of ownership
 - Customer acceptance

Recognize revenue when a performance obligation is satisfied - **Services**

- Services - performance obligation is satisfied continuously if:
 - Performance creates an asset that the customer controls **or**
 - Performance does not create an asset with alternative use and one of the following is met:
 - Customer receives benefit as the task is performed
 - Another entity would not need to re-perform the tasks performed to date
 - The entity has a right to payment for the performed task even if the customer could cancel the contract

Proposed model – Real estate sales

Existing guidance (ASC 360-20)

- Profit recognized in full for real estate sales when the following conditions are met:
 - Profit is determinable (collectability is reasonably assured or uncollectible amount can be estimated)
 - Earnings process is virtually complete (seller is not obligated to perform continuing activities to earn the profit or have continuing involvement)
- Profit recognized using full accrual method when following conditions are met:
 - Sale is consummated
 - Buyer's initial and continuing investments are adequate to demonstrate commitment to pay
 - Seller's receivable not subject to future subordination
 - Seller has transferred to buyer usual risks and rewards of ownership

Proposed guidance

- Collectability would affect measurement, not recognition, of revenue
 - Buyer and seller must be committed to satisfying their respective obligations under the contract
 - Transaction price and revenue recognized would be amount expected to be received at the date of sale
 - Revenue recognized only if the transaction price can be reasonably estimated
- Use of judgment when evaluating continuing involvement
- Transfer based on control rather than risks and rewards.

Proposed model – Construction industry

Existing guidance

- Revenue recognized using the percentage-of-completion method when reliable estimates are available
- Warranties that protect against latent defects are accounted for outside of the contract and in accordance with existing loss contingency guidance

Proposed guidance

- Revenue is recognized on the satisfaction of the performance obligations, which occurs when control of the good or service transfers to the customer
- Performance obligations can be satisfied at a point in time or continuously over time (must be demonstrated)
- Warranties that protect against latent defects do not give rise to a separate performance obligation – a portion of the contract revenue related to these expected warranties would be deferred at the time of sale

Proposed model – Hospitality customer loyalty programs

Existing guidance

- Lack of specific guidance has led to various practice of recording customer loyalty program obligations
- Many entities use an incremental cost method
- Some entities apply a multiple element model similar to the proposed model

Proposed guidance

- Accounted for as a separate component of revenue for which a performance obligation should be accrued
- The fair value of consideration received, e.g. room rate for the stay for which an award is granted, is allocated on a relative basis between the award and room revenue
- In cases where points/awards are not sold on a stand-alone basis, entities will have to estimate the value of awards based upon historical redemption trends and average room rates

Proposed model – Other considerations

Disclosure

- Qualitative and quantitative information about performance obligations and onerous contracts
- Amount and timing of remaining performance obligations
- Significant judgments and changes in judgments
- Reconciliation of contract balances
- Nonpublic entities exempt from certain disclosure requirements (FASB only)

Transition

- Full or “limited” retrospective application
- Expected effective date – no earlier than annual periods beginning on or after January 1, 2015
- Early adoption
 - IASB – permitted
 - FASB – not permitted

Financial instruments

Financial Instruments

Background

- FASB issued its comprehensive proposal in May 2010 on all aspects of financial instrument accounting – comment letter period ended September 30
- FASB hosted 5 public roundtables in October 2011
- Key themes from comment letters and roundtables included:
 - Significant concerns regarding non-convergence with IFRS
 - Disagree with fair value as measurement basis for all financial instruments
 - Consider the need for a third category to allow fair value measurement through OCI for debt investments held for liquidity or interest rate risk management purposes
 - Fair value of all equity investments presents challenges. The net income volatility for “strategic” investments questioned. No support for changes to equity method.
 - Consider enhanced risk management disclosures
 - Support reclassification
 - No support for the proposed impairment and interest income model
 - Support for simplification of hedge accounting but disagree with elements of the proposal

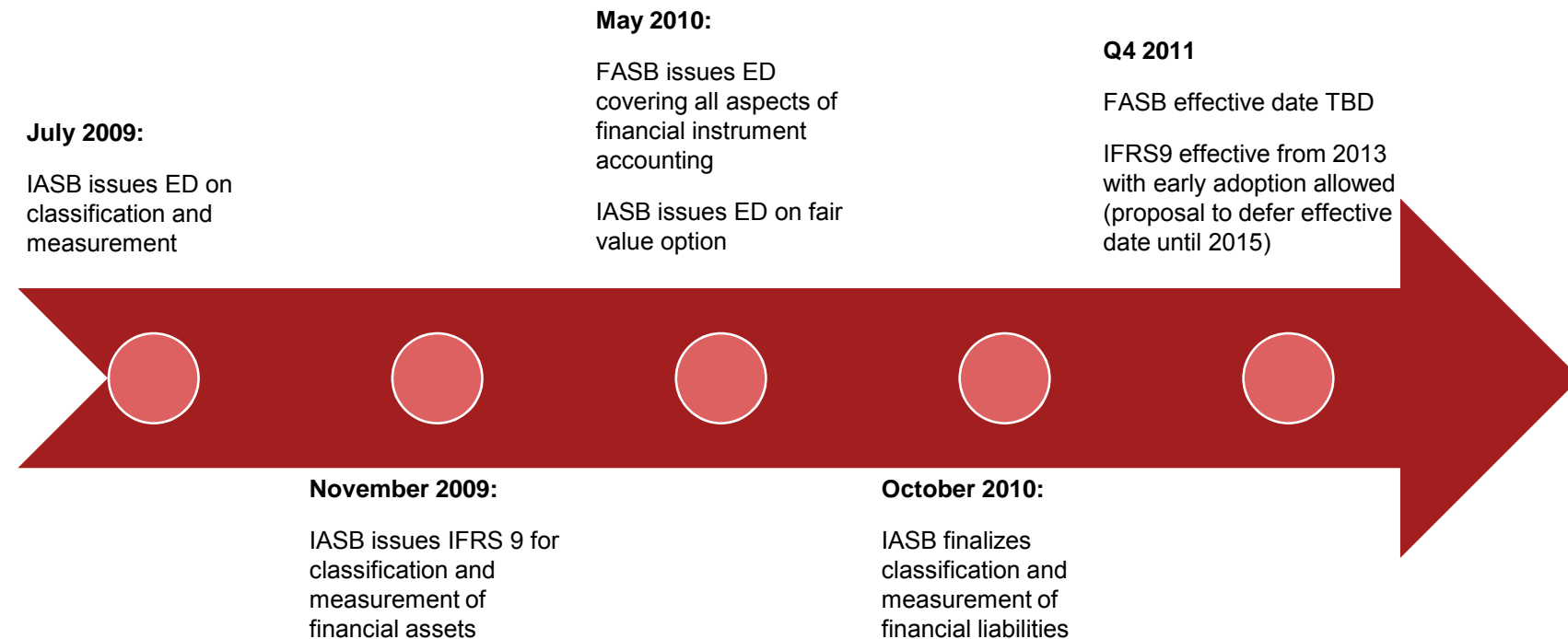
Financial Instruments (continued)

Current status

- FASB began redeliberations in December 2010. It has not yet completed deliberations on:
 - Scope
 - Disclosures, including risks
 - Presentation
- It is unclear at this stage whether the FASB will re-expose
- The IASB Chairman has stated that the IASB will seek constituent views on FASB approach
- Once the FASB has developed its model, it plans on engaging with the IASB to reconcile differences
- The FASB has changed to a 3-category mixed measurement approach (amortized cost, fair value through OCI, fair value through net income). In contrast, the IASB developed and has finalized a 2-category mixed measurement approach (amortized cost and fair value through net income).
- Both the FASB and IASB would classify financial assets based on the entity's business model and the individual instrument's characteristics

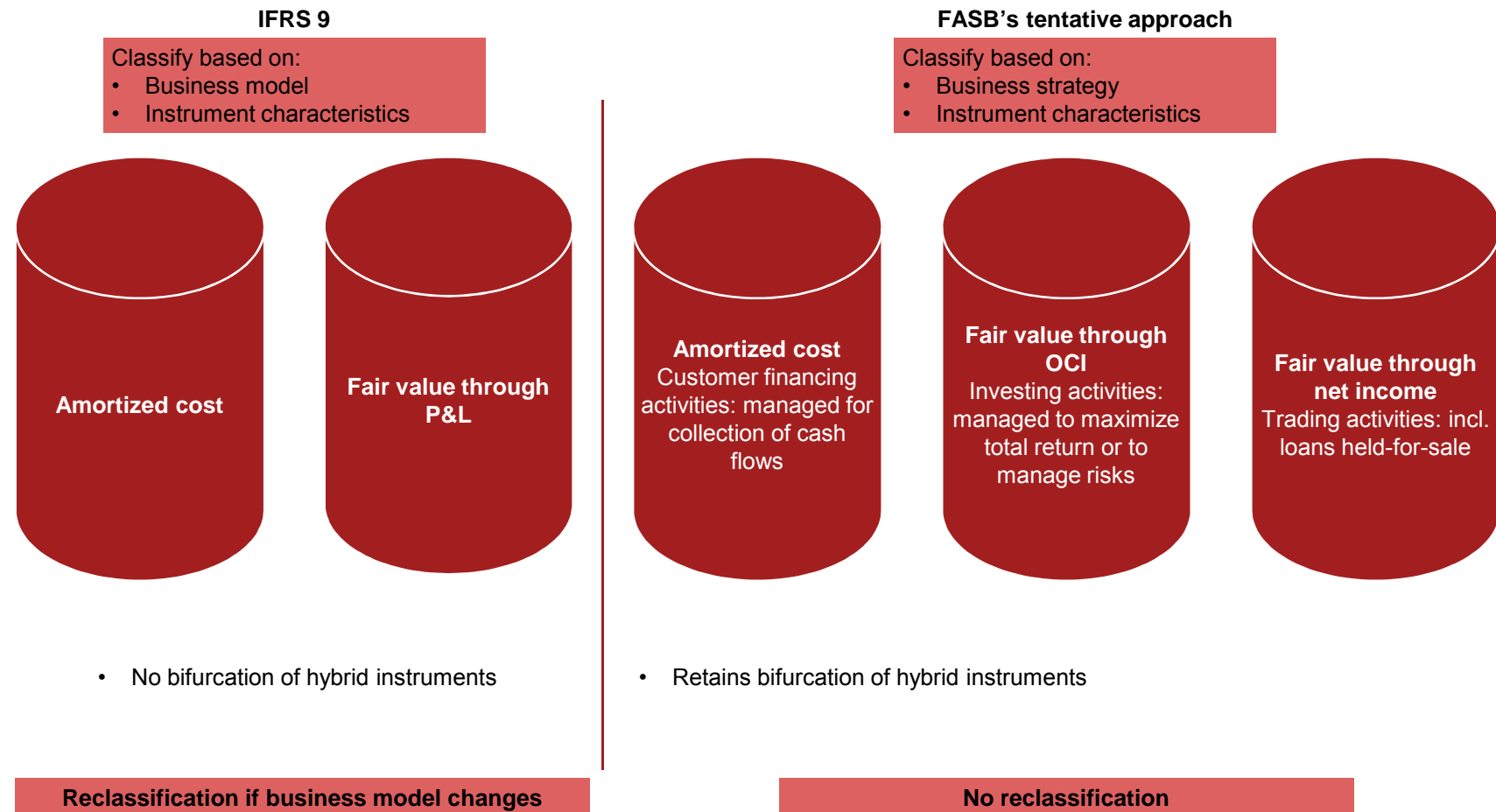
Financial Instruments (continued)

Timeline



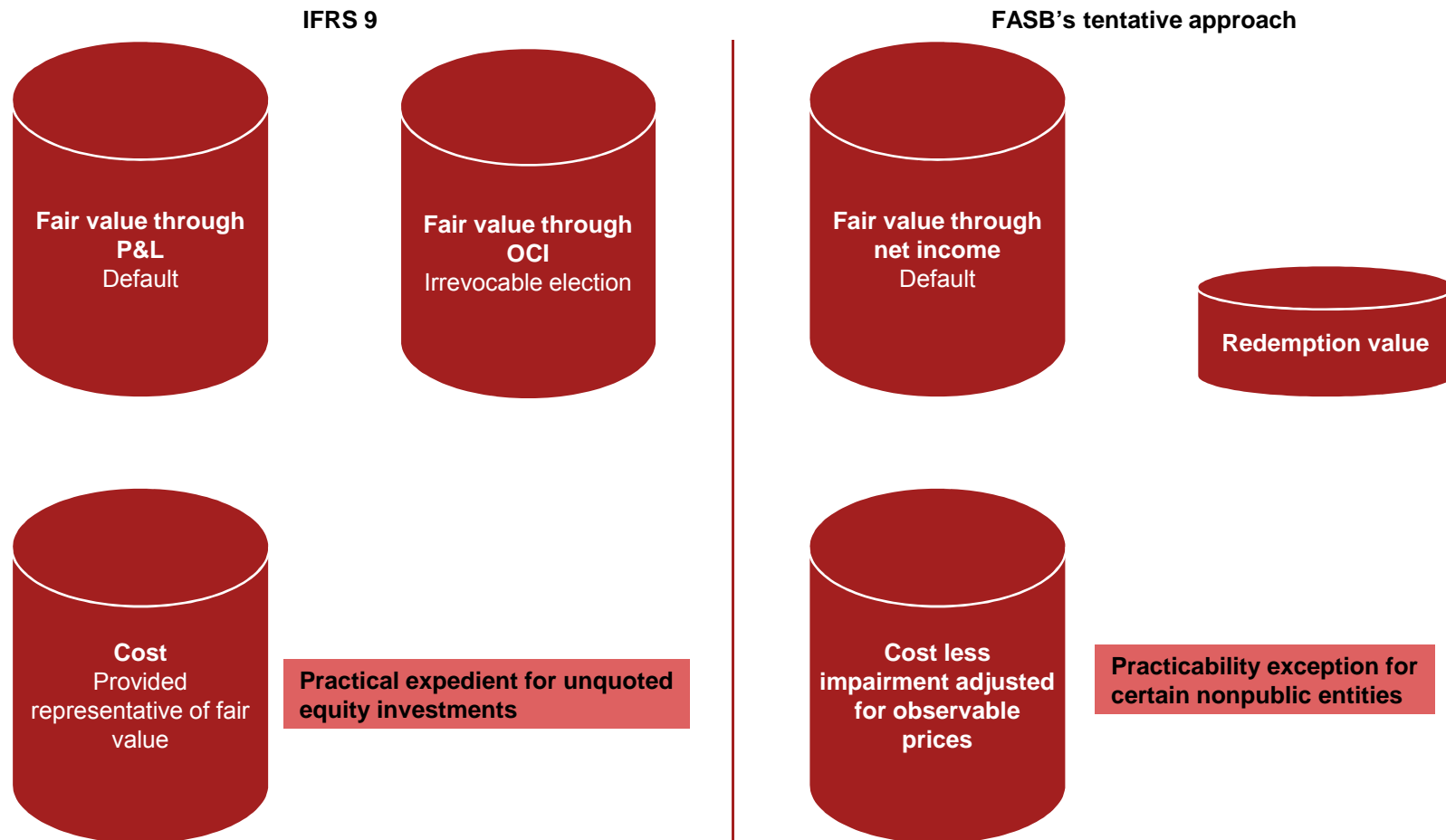
Financial Instruments (continued)

Comparison of FASB and IASB's classification and measurement approach – Debt investments



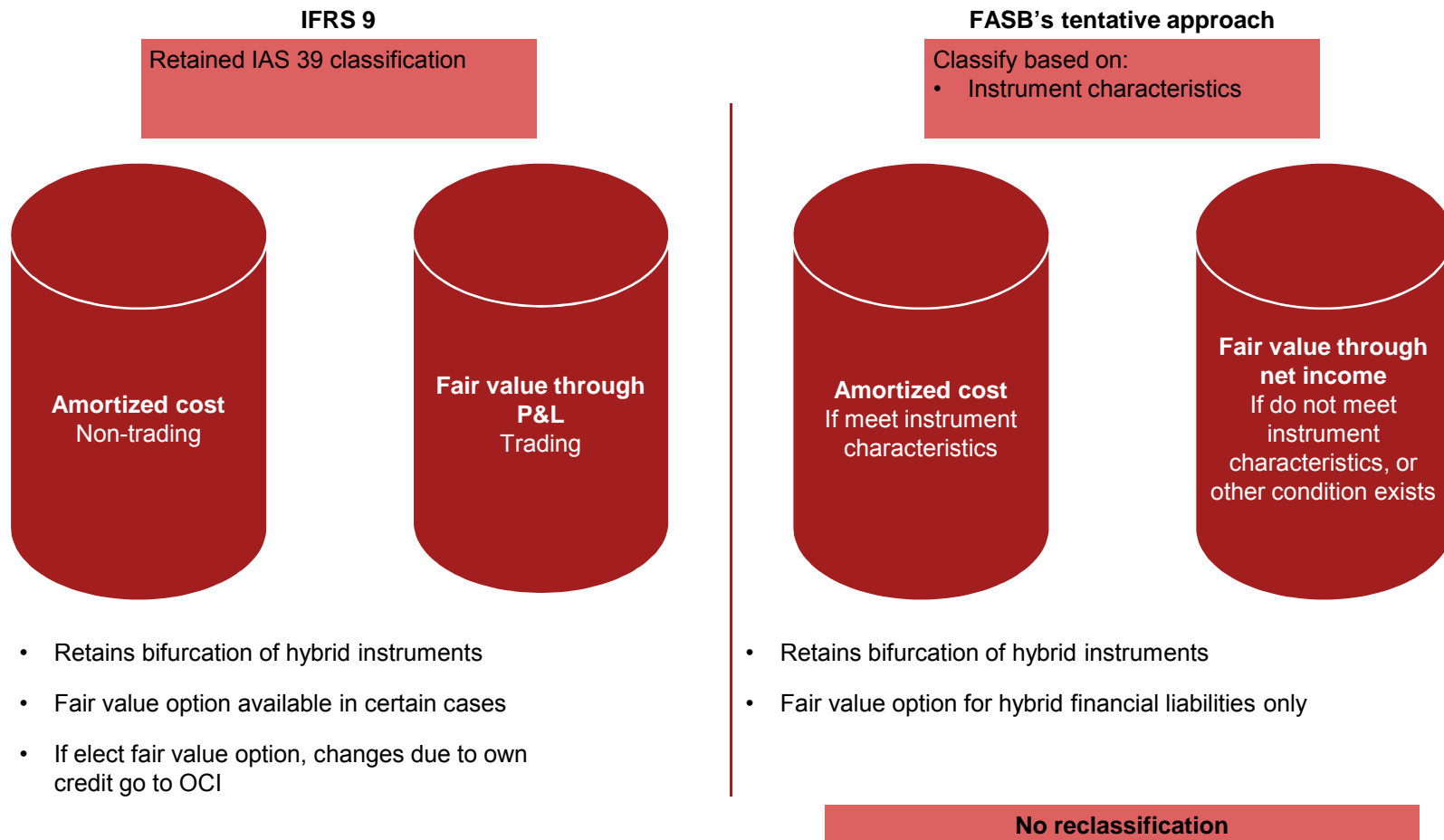
Financial Instruments (continued)

Comparison of FASB and IASB's classification and measurement approach — Equity investments



Financial Instruments (continued)

Comparison of FASB and IASB's classification and measurement approach — Financial liabilities



Financial Instruments (continued)

Instrument characteristics criterion (assets and liabilities)

To be eligible for amortized cost or FV-OCI (assets only), **all** of the following criteria must be met:

Characteristics	Explanation
1. Not a derivative instrument subject to ASC 815	
2. Amount is transferred to the issuer at inception (principal adjusted for any discount or premium) that will be returned at maturity or settlement	<ul style="list-style-type: none">• Amount transferred can include goods or services i.e. A/R and A/P should qualify• Equity investments do not qualify• Convertibles do not qualify – however, exception to require entire convertible to be at amortized cost if no equity component – if separate equity component, can host contract meet this criterion (instrument B, C and X)?
3. Cannot be contractually prepaid/settled so that the investor would not recover substantially all of its initial investment (other than through its own choice)	<ul style="list-style-type: none">• Prepayable instrument at substantial premium and interest-only strips may not meet this criterion

Financial Instruments (continued)

Business strategy criterion for financial assets

Categories	Explanation
1. Amortized cost	<p>Must meet all of the following:</p> <ul style="list-style-type: none">• Business strategy is to manage through customer financing (lending or borrowing) activities – primary focus on collection or payment of substantially all contractual cash flows• Holder has ability to manage credit risk by negotiating any potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss. Sales or settlements limited to circumstances that would minimize losses due to deteriorating credit.• Not held for sale (assets) or transfer (liabilities)
2. FV-OCI (assets only)	<p>Must meet all of the following:</p> <ul style="list-style-type: none">• Business strategy is to invest the cash of the entity either to:<ol style="list-style-type: none">a. Maximize total return by collecting contractual cash flows or sellingb. Manage the interest rate or liquidity risk of the entity by holding or selling• Not held for sale at acquisition or issuance
3. FV-NI	<p>Must meet either of the following:</p> <ul style="list-style-type: none">• Held for sale (assets) or transfer (liabilities) at acquisition• Actively managed and monitored internally on a fair value basis but do not qualify for the FV-OCI category

Financial Instruments (continued)

Classification of financial liabilities

Categories	Explanation
1. Amortized cost	<p>Must meet all of the instrument characteristics</p> <ul style="list-style-type: none">• Not a derivative• Amount is transferred to issuer at inception that will be returned at maturity or settlement• Cannot be contractually prepaid/ settled so that the investor would not recover substantially all of its initial investment (other than through its own choice) <p>Cannot be a short sale or be held for transfer where the entity has the ability and means to transact at fair value</p>
2. FV-NI	<p>Either</p> <ul style="list-style-type: none">• It does not meet all of the instrument characteristics criteria• It is a short sale• It is held for transfer at inception and holder has ability and means to transact at fair value

Financial Instruments (continued)

Presentation of financial assets and liabilities

- **Balance sheet:**

- Separately present assets and liabilities by measurement category
- For assets and liabilities at amortized cost (excluding demand deposits), public entities must present fair value parenthetically on the face
 - Fair value must be based on exit price as per ASC 820
 - Fair values not required for short term (less than one year) receivables and payables
- For assets at amortized cost, present cumulative credit losses on the face
- For liabilities at fair value, present amortized cost parenthetically on the face

- **Income statement:**

- For assets and liabilities at FV-NI, present aggregate amount for realized and unrealized gains or losses
- For assets at amortized cost or FV-OCI, separately present interest income, credit losses, realized gains and losses
- For liabilities at amortized cost, separately present interest expense, realized gains and losses

Financial Instruments (continued)

Impairment

- Many constituents consider impairment the most important area for convergence.
- The Boards began joint redeliberations in November 2010, and in January 2011 a supplementary document proposing new impairment approaches.
- Based on constituent feedback, the Boards have decided to develop a “3 bucket” approach that is a variation of the proposals. The 3 buckets reflect the general pattern of deterioration of credit quality of assets.

Financial Instruments (continued)

What are the 3 buckets

Bucket 1

Assets **unaffected by observable events that provide direct evidence of a possible future default** (including loans with changes in credit loss expectations from macroeconomic events that are not particular to either a group of loans or a specific loan).

Bucket 2

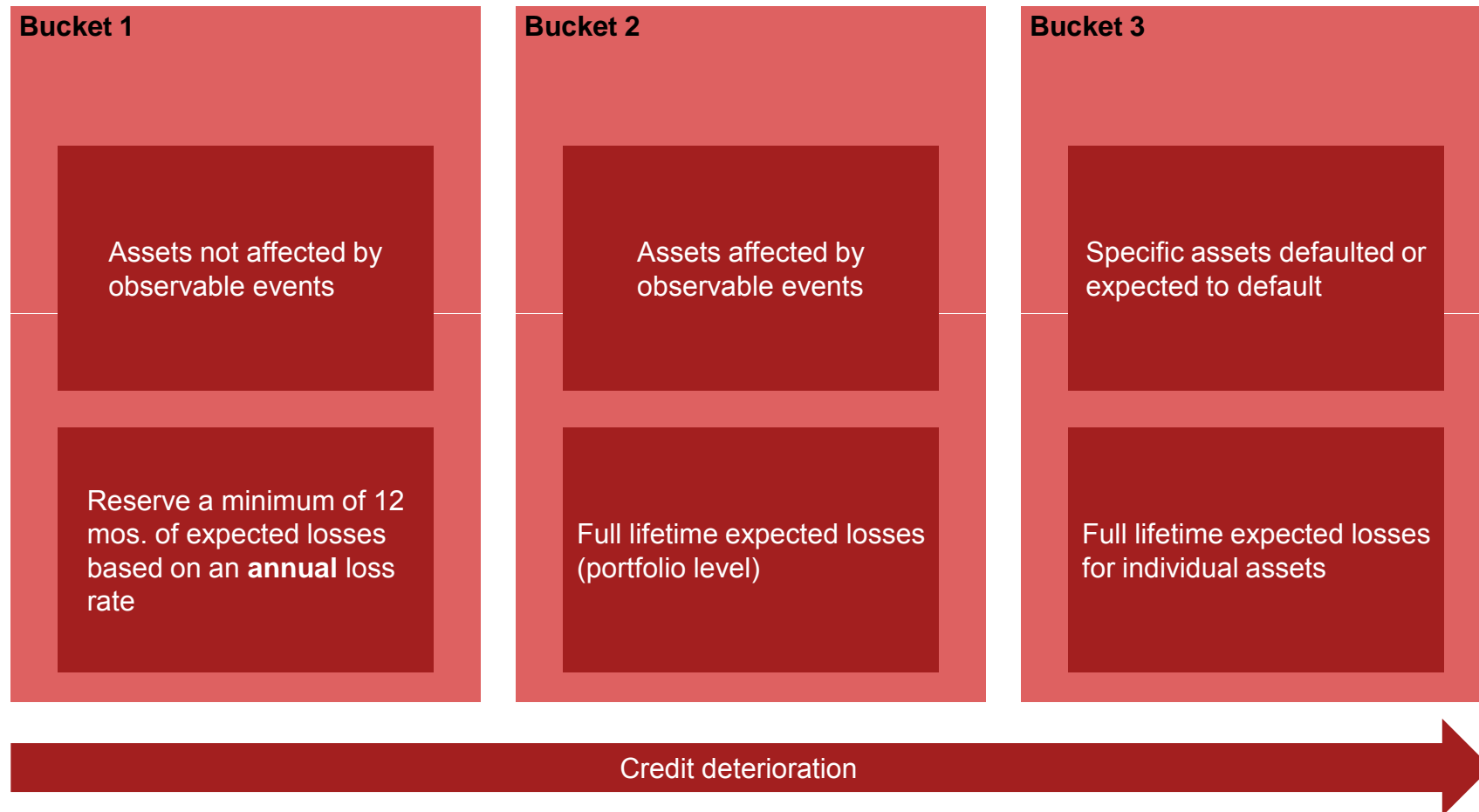
Assets affected by the occurrence of events that indicate a direct relationship to possible future defaults, but **specific assets in danger of default have not yet been identified.**

Bucket 3

Assets for which information is available that **specifically identifies that credit losses** are expected to, or have, occurred on individual assets.

Financial Instruments (continued)

How much is the allowance in each bucket



Financial Instruments (continued)

Hedge accounting

- The IASB issued an exposure draft on hedge accounting in December 2010 resulting from a comprehensive review of its hedge accounting guidance.
 - The FASB also obtained feedback on the IASB's hedge accounting proposals.
- However, the FASB has, for the most part, brought forth its proposals from its previous hedge accounting exposure draft issued in 2008.
- The FASB has deferred redeliberating on hedge accounting until it formally receives feedback on the IASB's model.
- Consequently, the FASB is not expected to finalize its hedge accounting guidance before the end of 2011.

Financial Instruments (continued)

Overview — Comparing the boards' proposals

FASB 2010 proposal	IASB proposal	FASB discussion paper
<ul style="list-style-type: none">• Objective is simplification; targeted changes proposed• Easier to qualify for hedge accounting (reasonably effective)• Less onerous hedge effectiveness assessment requirements• Removal of shortcut and critical terms match methods• Cannot elect to “stop” hedge accounting	<ul style="list-style-type: none">• Objective is simplification and linkage to risk management activities• Proposals are broader and in some cases more flexible than the FASB’s• Concept of effectiveness as well as what can be hedged, is different from FASB’s proposal• Cannot elect to “stop” hedge accounting• Requires new disclosures	<ul style="list-style-type: none">• Seeks views regarding understandability, operability, and auditability of the IASB’s proposal• Asks whether FASB should aim for convergence, or targeted improvements to U.S. GAAP for hedge accounting• Feedback to be considered in redeliberations

Newly issued standards and others on the horizon

Joint FASB/IASB project: Consolidation

Background:

- In June 2009, FASB issued amendments to the VIE model (FAS 167)
- However, in February 2010, responding to significant concern about the unintended consequences of FAS 167 the FASB issued a temporary deferral to certain investment entities
- Separately, in December 2008, the IASB issued its proposed consolidation guidance for all entities (ED 10)
- With an eye towards convergence , FASB and IASB have jointly deliberated IASB's proposed consolidation guidance since October 2009
- The FASB held roundtables in November 2010 to gather constituent input on the IASB Staff Draft and determine the way forward
- The IASB issued its final standard on consolidation in May 2011.
- The FASB released its ED on consolidation on November 3, 2011 with comments due January 17, 2012

Joint FASB/IASB project: Consolidation

Summary of proposed changes:

- After considering US stakeholder input, the FASB decided not to propose converging with IFRS in all these areas but instead only eliminate the temporary deferral for certain investment entities by:
 - Adopting guidance that is consistent with IFRS for distinguishing whether a decision-maker is an agent or a principal
 - Amend the kick-out rights guidance for voting interest entities for greater consistency in consolidation literature
- Proposal would apply to both public and non-public companies that have variable interests in VIEs as well as limited partnerships currently assessed under the voting interest model

Joint FASB/IASB project: Consolidation

Assessing principal versus agent relationships – factors to consider:

- Rights held by others – substantive kick-out rights may indicate the decision maker is an agent rather than a principal
 - Single party with substantive rights to remove decision-maker without cause = decision-maker is agent
 - The more parties needed to remove the decision-maker, the less weight placed on those rights
 - Participating and liquidation rights viewed similar to removal rights
- Compensation of the decision-maker
 - Compensation not commensurate with level of services, decision-maker is likely to be a principal
- Other interests held by decision-maker
 - The greater a decision-maker's exposure to variable returns, the more likely it is acting as a principal

FASB project: Goodwill impairment assessments

- On September 15, FASB issued a final standard to ‘simplify’ goodwill impairment accounting
 - Impacts both public and private entities
 - Will be effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011; early adoption is permitted
- What are the proposed changes?
 - Entities would have the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not (i.e. greater than 50% likelihood) that the fair value of a reporting unit is less than its carrying amount. Must clearly document decision to bypass the quantitative test.
 - If it is more likely than not – perform two step impairment test as before
- Stay tuned – FASB has added project for simplification of impairment for indefinite-lived intangible assets

Presentation of other comprehensive income – harder than it looks?

- In June 2011 the FASB issued a final ASU on the presentation of comprehensive income
- Most significant change is the elimination of the option to present it as part of the equity statement.
- Reclassification adjustments will need to be shown on the face of the income statement (in both single and two-statement formats).
- Complying with the requirements may not be straightforward for companies with reclassification adjustments that affect multiple line items (e.g., pension-related adjustments)
- Effective as of the beginning of a fiscal reporting year that begins after December 15, 2011 for US GAAP (public companies) and for fiscal reporting years that begin on or after July 1, 2012 for IFRS.

Blue-Ribbon Panel on standard setting for private companies

- The Blue-Ribbon Panel on Standard Setting for Private Companies was formed in late 2009 by the AICPA, FAF and NASBA to address the needs of U.S. users of private company financial statements, including an analysis of the standard-setting process.
- The Panel met several times throughout 2010 to discuss the input that was received from preparers, auditors and users of private company financial statements, as well as from international standard-setting bodies.
- On January 26, 2011, the Panel issued its report to the Board of Trustees of the FAF, recommending significant modifications to the current accounting standard-setting process for private companies.

Blue-Ribbon Panel on standard setting for private companies

The Panel's Recommendations

- Creation of a new standard-setting board under the oversight of the FAF that would propose exceptions and modifications to U.S. GAAP for private companies
 - The new board would work closely with the FASB with the goal of having a coordinated and efficient standard-setting process, with final authority vested with the new board.
- Creation of a framework to provide guidance on when exceptions and modifications may be appropriate for private companies
- Certain other near-term actions were recommended to provide relief for private companies and to ensure a smooth transition to the new board.

Blue-Ribbon Panel on standard setting for private companies

Next Steps

- The FAF Board of Trustees will consider the Panel's recommendations as it continues to deliberate improvements to the standard-setting process.
- The Trustees will be making additional outreach regarding what modifications should be made.
- Ultimately, the FAF will seek input from a broad base of constituents through a discussion paper, expected later in 2011.

Regulatory update

Key areas impacting asset managers

- Dodd-Frank Act
 - Registration of advisors of private funds
 - Reporting requirements for exempt reporting advisors
- AIFM Directive – regulates all AIFMs distributing in the EU, whether managed in the EU or another country
- SEC Custody Rule 206 – applies to investment advisors registered with the SEC and who have “custody” of client assets and was effective March 12, 2010

Impact of Dodd-Frank Act – SEC Reports on Sarbanes-Oxley, no changes recommended

- The Dodd-Frank Act directed the SEC to perform a study of how it could reduce the burden of compliance with Sarbanes-Oxley Section 404(b) for issuers with \$75-\$250 million in public float
- The SEC's report recommends keeping the existing requirements
- The report also encourages activities that have the potential to further increase the effectiveness and efficiency of Section 404(b) implementation

PCAOB kicks off debate on auditor rotation and reporting

- PCAOB issued two concept releases this summer focusing on the auditor's reporting model and audit firm rotation
- The first release outlines several potential alternatives to the current auditor's report with comments requested by September 30, 2011
- The second release largely focuses on mandatory audit firm rotation and also requests input on other ways to enhance auditor independence, objectivity, and professional skepticism; comments are requested by December 14, 2011

Questions?

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