

NCREIF Conference

Accounting Committee Presentation
February 24-25, 2010



Agenda

February 24, 2010

- REIS Council Update
- PREA Update
- Debt Valuation Webinar Update
- Chicago Academy Week Discussion
- Subcommittee meeting time

Agenda

February 25, 2010

- Hot Topics
 - Accounting for Variable Interest Entities
 - Foreclosures
 - Subsequent events
 - Impairment assumptions
 - Modifications of debt
 - Fair Value Measurements

- GIPS 2010
 - Major impacts for real estate fund reporting

Variable Interest Entities

Q: What is the big difference between FIN 46R and FAS 167?

A: Under FAS 167, the primary beneficiary of a VIE is the enterprise that both (a) has the power to direct the activities of a VIE that most significantly impact the entity's economic performance and (b) has the obligation to absorb losses of the entity that could potentially be significant to the VIE or the right receive benefits from the entity that could potentially be significant to the VIE.

Thus, FAS 167 eliminates an enterprises ability to use probability when identifying an entity's primary beneficiary and introduces the importance of identifying the "power to direct activities that most significantly impact the economic performance of a variable interest entity."

Variable Interest Entities (VIEs) – Recap

VIEs are entities that have one of the following characteristics:

- Insufficient equity investment at risk (5a)
- Holders of equity investment at risk lack certain characteristics (5b)
- Substantially all activities are conducted on behalf of an equity investor with disproportionately few voting rights (5c)

Variable Interest Entities (VIEs) – Recap

Paragraph 5b: Holders of equity investment at risk lack:

- Power to direct the activities that most significantly impact the entity's economic performance (5b1)
 - Kick out rights by majority were considered (until SFAS No.167)
- Obligation to absorb expected losses (5b2)
- Right to receive expected residual returns (5b3)

Variable Interest Entities cont'd

Q: What about kick-out rights or participating rights when determining whether the holders of the equity investment at risk have the power to direct the entity's activities?

A: A single holder of the equity investment at risk would need to have the unilateral ability to exercise these rights in order for them to be considered to prevent another variable interest from having the power to direct the entity's activities that most significantly impact the entity's performance.

Variable Interest Entities cont'd

Q: Are fees earned by managers/other service providers considered to be variable interests?

Variable Interest Entities cont'd

A: It depends. Fees are not variable interests if all of the following criteria from paragraph B22 are met:

- a) The fees are compensation for services provided and are commensurate with the level of effort required to provide those services
- b) Substantially all the fees are at or above the same level of seniority as other operating liabilities of the entity that arise in the normal course of the entity's activities.
- c) The decision maker or service provider and its related parties, if any, do not hold other interests in the variable interest entity that individually, or in the aggregate, would absorb more than an insignificant amount of the entity's expected losses or receive more than an insignificant amount of the entity's expected residual returns.

Variable Interest Entities cont'd

- d) The service arrangement includes only terms, conditions or amounts that are customarily present in arrangement for similar services negotiated at arm's length.
- e) The total amount of anticipated fees are insignificant relative to the total amount of the variable interest entity's anticipated economic performance.
- f) The anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity's anticipated economic performance.

For many property managers, criteria (c) is problematic, as they often also hold equity investments or other variable interests that may be significant.

Variable Interest Entities cont'd

Q: What does “insignificant amount of the entity’s expected losses/residual returns referenced in (c), (e), and (f) mean?

A: While there is no bright-line, 10 percent of the expected losses/residual returns can be used as a general guideline. Note this expectation is a probability-based measure, as opposed to determining the primary beneficiary.

Variable Interest Entities cont'd

Q: What if the “power to direct an entity’s activities that most significantly impact its performance” is granted to an equity holder separately from its equity interest that qualifies as equity investment at risk?

Q: Does that cause an entity to lack the characteristic of the equity at risk having the power to direct the activities of an entity that most significantly impact the entity’s economic performance described in paragraph 5(b)(1) of Interpretation 46(R), as amended by Statement 167?

Variable Interest Entities cont'd

A: It depends. A separate management agreement that grants decision making rights, or power, could affect the equity holders' power to direct under paragraph 5(b)(1) even if the manager, under the management agreement, also holds an equity investment in the entity.

Variable Interest Entities cont'd

Example:

A limited partnership is formed by a general partner (GP) and various limited partners (LPs) with \$100 million of equity, all of which meets the definition of equity at risk under paragraph 5(a) of Interpretation 46(R), as amended by Statement 167. The sole GP provides all day-to-day investment decisions. When the partnership is formed, the GP makes an initial equity investment of \$1,000.

Variable Interest Entities cont'd

Q: In the above scenario, how does the conclusion that the GP's initial investment is not equity at risk affect whether, under paragraph 5(b)(1) of Interpretation 46(R), as amended by Statement 167, the holders of equity at risk, as a group, are able to make decisions about the partnership's activities that have a significant effect on its success?

Variable Interest Entities cont'd

A: According to paragraph 5(b)(1), the fees paid to the GP must be evaluated under paragraph B22 of Interpretation 46(R), as amended by Statement 167, to determine whether the GP has a variable interest in the partnership. If the fees paid to the GP meet all of the conditions in paragraph B22, then the GP does not have a variable interest in the partnership. If the fees paid to the GP meet all of the conditions in paragraph B22, then the GP does not have a variable interest in the partnership. If the GP does not have a variable interest in the partnership, then the decision making power held by the GP would not prevent the equity holders from having the characteristic described in paragraph 5(b)(1). One would need to consider other facts to make a conclusion.

Variable Interest Entities cont'd

However, if after evaluating the fees paid to the GP under paragraph B22 it is determined that the decision maker does have a variable interest in the entity, then the equity holders lack the characteristic in paragraph 5(b)(1) and the partnership is a variable interest entity (VIE).

Variable Interest Entities cont'd

The determination of whether the management agreement is truly separate requires an evaluation of all of the relevant facts and circumstances.

For example, if a general partner (with an equity interest and a separate management agreement) cannot dispose of its equity interest and still maintain its decision making rights under the management agreement, the management agreement and the equity interests are unlikely to be considered substantively separate. In addition, the absence of valid and compelling business reasons for having decision maker rights documented separately from the equity interests is an indicator that the arrangement may have been designed solely or principally to achieve an accounting result.

Variable Interest Entities cont'd

A GP and several LPs form a partnership. Assume that the GP makes no or a nonsubstantive equity investment, the LPs hold equity at risk, and no other arrangements would cause the partnership to be a VIE under Interpretation 46(R), as amended by Statement 167. The GP and one of the LPs (LP1) are controlled by the same parent.

Variable Interest Entities cont'd

Because the GP and LP1 are controlled by the same parent, they are related parties under ASC 850-10. This related-party relationship is also presumptively so significant that the interests of the parties should be viewed in the aggregate because the common parent can make decisions for both the GP and LP1. Therefore, in the absence of evidence to the contrary, the GP and LP1 interests should be considered in the aggregate under paragraph 5(b)(1). As a result, the group of equity holders (GP and LPs) may not lack the characteristic described in paragraph 5(b)(1); therefore, the partnership may not be a VIE.

Impairment and Subsequent Events

Impairment Issues

Company A assesses impairment losses of long-lived assets on the basis of assets grouped at the store level. When determining future cash flows to assess whether an impairment exists as of December 31, 20X9, A adjusts the 20X9 actual results by assumptions based on its best estimate of declines (or increases) in cash flows as of December 31, 20X9.

After making this assessment, but before the December 31, 20X9, financial statements are issued or are available to be issued, A's board of directors approves and announces plans to close a significant number of stores. Company A's impairment analysis, in accordance with ASC 360-10, does not presently consider the effects of the store closings announced after year-end.

Impairment Issues

- Q: Should A adjust its impairment analysis to consider the effects of the recently announced store closings?

Impairment Issues

- No. ASC 855-10-20 defines recognized subsequent events as events that “provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements.”

Impairment Issues

- ASC 855-10-55-1 provides the following additional guidance on recognized subsequent events:
 - a. If the events that gave rise to litigation had taken place before the balance sheet date and that litigation is settled after the balance sheet date but before the financial statements are issued or are available to be issued, for an amount different from the liability recorded in the accounts, then the settlement amount should be considered in estimating the amount of liability recognized in the financial statements at the balance sheet date.

Impairment Issues

- b. Subsequent events affecting the realization of assets, such as receivables and inventories or the settlement of estimated liabilities, should be recognized in the financial statements when those events represent the culmination of conditions that existed over a relatively long period of time. For example, a loss on an uncollectible trade account receivable as a result of a customer's deteriorating financial condition leading to bankruptcy after the balance sheet date but before the financial statements are issued or are available to be issued ordinarily will be indicative of conditions existing at the balance sheet date. Thus, the effects of the customer's bankruptcy filing shall be considered in determining the amount of uncollectible trade accounts receivable recognized in the financial statements at balance sheet date.

Impairment Issues

- In the example above, A has already evaluated the stores on a cash flow basis before the announcement and has recorded necessary impairment charges on that basis.
- Accordingly, the decision does not constitute evidence that additional impairment existed as of the balance sheet date. Rather, the decision to close stores after year-end is a nonrecognized subsequent event under ASC 855 that will require a separate impairment evaluation and perhaps an incremental impairment charge in the following year.

Impairment Issues

- Q: In an undiscounted cash flow analysis should one include an inflow upon foreclosure in the amount of the debt balance being “forgiven.”
- A: One can assume that the lender is essentially buying the property from the owner for the debt amount. But, and this is important, the imputed cash inflow at foreclosure from the debt forgiveness *must not be greater than the fair value of the property.*

Impairment Issues

■ Book value of property	\$2,000
■ Debt amount	1,500
■ Fair value of property	1,700

In the undiscounted cash flow analysis, at foreclosure, cash inflow would be \$1,500. Property is probably impaired.

Impairment Issues

■ Book value of property	\$2,000
■ Debt amount	2,100
■ Fair value of property	1,700

This impairment analysis would show a cash inflow of \$1,700 at the projected foreclosure date.

In this second scenario, the property would be written down to fair value of \$1,700 with a \$300 impairment charge, and when the foreclosure *actually occurs*, there would be a gain on debt extinguishment of \$400. (Assuming debt is not at fair value)

Debt Modifications

Debt modification examples

Borrowers Accounting for TDRs

Case Facts

As of December 31, 2009, Company A has a note payable to Lender with the following terms:

- Principal balance: \$100,000
- Accrued interest: \$10,000
- Interest rate: 5 %
- Remaining life: 5 years

Debt modification

Borrowers Accounting for TDRs

Due to Company A's financial difficulties, Lender agreed to modify the note by reducing the principal amount by \$20,000 to make the outstanding amount \$80,000. In addition, the stated interest rate was lowered to 4%, and all accrued interest was forgiven on the date of the modification. Interest is payable on December 31 each year. Principal is due December 31, 2014. The terms of the agreement contain a provision that if Company A increases its annual operating cash flows by \$50,000 or 3%, by December 31, 2010, the Company would be required to pay Lender an additional \$2,000. The modification is effective December 31, 2009.

Debt modification

Borrowers Accounting for TDRs

Q: What type of restructuring does this TDR represent?

A: Modification of terms. Company A did not transfer assets or grant equity interests or a combination thereof.

Debt modification

Borrowers Accounting for TDRs

Q: How should Company A record the modifications of its note payable.

A: Company A should reduce the carrying value of the note payable and recognize a gain on restructuring in accordance with ASC 470-60-35-6 *If, however, the total future cash payments specified by the new terms of a payable, including both payments designated as interest and those designated as face amount, are less than the carrying amount of the payable, the debtor shall reduce the carrying amount to an amount equal to the total future cash payments specified by the new terms and shall recognize a gain on restructuring of payables equal to the amount of the reduction. Thereafter, all cash payments under the terms of the payable shall be accounted for as reductions of the carrying amount of the payable, and no interest expense shall be recognized on the payable for any period between the restructuring and maturity of the payable.*

Debt modification

Borrowers Accounting for TDRs

To determine the journal entries to record the modification, first we must determine if the future cash payments specified by the new terms are greater or less than the carrying amount of the payable.

Step 1 - Determine the carrying amount:

Principal balance:	\$100,000
Accrued interest:	<u>10,000</u>
Total carrying amount:	<u>\$110,000</u>

Debt modification

Borrowers Accounting for TDRs

Step 2 – Determine the future cash payments under the restructured terms:

Principal balance:	\$ 80,000	
Interest:	16,000	(5 years x \$80,000 x 4%)
Contingent payable	<u>2,000</u>	(Operating cash flows)
Total future cash flows:	<u>\$ 98,000</u>	

Debt modification

Borrowers Accounting for TDRs

Step 3 – Measure the gain:

Carrying amount pre-restructuring:	\$110,000
Carrying amount post-restructuring:	<u>98,000</u>
Total gain on restructuring:	<u>\$ 12,000</u>

The journal entry to record the gain would be as follows:

Entry Date: December 31, 2009

Dr. Interest payable	\$10,000	
Dr. Note payable	\$ 2,000	
		Cr. Gain on restructuring
		\$12,000

Debt modification

Borrowers Accounting for TDRs

A: All future cash payments are included in the determining the carrying value subsequent to the restructured terms (interest, principal payments and contingent amounts).

Debt modification

Borrowers Accounting for TDRs

A: Contingent payable amounts are assumed to be paid see ASC 470-60-35-7 *Amounts designated either as interest or as face amount by the new terms may be payable contingent on a specified event or circumstance (for example, the debtor may be required to pay specified amounts if its financial condition improves to a specified degree within a specified period). To determine whether the debtor shall recognize a gain according to the provisions of the preceding two paragraphs, those contingent amounts shall be included in the total future cash payments specified by the new terms to the extent necessary to prevent recognizing a gain at the time of restructuring that may be offset by future interest expense. Thus, the debtor shall apply paragraphs 450-30-25-1 and 450-30-50-1 in which probability of occurrence of a gain contingency is not a factor, and shall assume that contingent future payments will have to be paid.*

Debt modification

Borrowers Accounting for TDRs

Q: Assume that the Company had to pay \$5,000 to XLP Consulting for work performed relating to the restructuring and a \$2,000 payment to its outside legal counsel. How should Company A record the gain relating to the modification?

A: The carrying amount would be determined the same way as in question 1; however the gain calculation would be as follows:

Measure the gain:

Carrying amount pre-restructuring:	\$110,000
Carrying amount post-restructuring:	(98,000)
Less direct costs paid:	<u>(7,000)</u>
Total gain on restructuring:	<u>\$ 5,000</u>

Debt modification

Borrowers Accounting for TDRs

A: When a gain is recognized, legal fees and other direct costs that a debtor incurs are deducted when measuring a gain on restructuring or included as a period expense if no gain is recognized.

ASC 470-60-35-12 Legal fees and other direct costs that a debtor incurs in granting an equity interest to a creditor in a troubled debt restructuring shall reduce the amount otherwise recorded for that equity interest according to paragraphs [470-60-35-4](#) and [470-60-35-8](#). All other direct costs that a debtor incurs to effect a troubled debt restructuring shall be deducted in measuring gain on restructuring of payables or shall be included in expense for the period if no gain on restructuring is recognized.

ASU 2010-06

Improving Disclosures About Fair Value
Measurements

ASU 2010-06—*Fair Value Measurements and Disclosures* (Topic 820): *Improving Disclosures about Fair Value Measurements*

Level of disaggregation	<ul style="list-style-type: none">• Provide by each “class” of assets and liabilities, and their placement in the hierarchy (i.e., Level 1, 2, or 3)
Inputs and valuation	<ul style="list-style-type: none">• For Level 2 and 3: Describe the valuation techniques and inputs used for each class of assets or liabilities; if the valuation technique has changed, the change and the reason for the change should be disclosed
Level 1, 2, 3 transfers	<ul style="list-style-type: none">• Significant transfers between Levels 1 and 2 and the reasons for those transfers; transfers into and out of Level 3 and reasons for transfers
Reconciliation – Level 3 measurement	<ul style="list-style-type: none">• Total gains and losses recognized in OCI• Purchases, sales, issuances and settlements (each type disclosed separately)• Transfers into and out of Level 3 (separately when significant) and the reasons for the transfers

GIPS 2010

Significant Impact on Real Estate Funds