

NCREIF Academy

Accounting Hot Topics

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*connectedthinking

Agenda

- US Real Estate Capital Sources
- Real Estate Accounting Practices
- Pending Real Estate Fund Guidance
- Fair Value Measurements
- Q&A

US Real Estate Capital Sources 2008 (\$ in Billions)*

Private RE Debt	\$2,489	51.2%
Public RE Debt	1,110	22.8%
Private RE Equity	818	16.8%
Public RE Equity	<u>441</u>	9.2%
Totals	<u>\$4,858</u>	100.0%

- \$4.9 trillion in US commercial real estate, excludes corporate, government, non-profit as well as single family/owner-occupied residences
- Over \$10 trillion in total US commercial RE, exclusive of single family
- Estimated \$20 trillion in US single family housing
- Compare with \$15 trillion US stock market and \$25 trillion US bond market

* Source: *Emerging Trends in Real Estate 2009*, a publication of the Urban Land Institute & PricewaterhouseCoopers LLP

US RE Capital Sources 2008 – Equity (\$ in Billions)*

Private Equity:

Private investors (Hedge Funds, HNW, etc)	\$552
Pension Funds	157
Foreign Investors	55
Life Insurance Companies	34
Financial Institutions	<u>20</u>
	<u>818</u>

Public Equity:

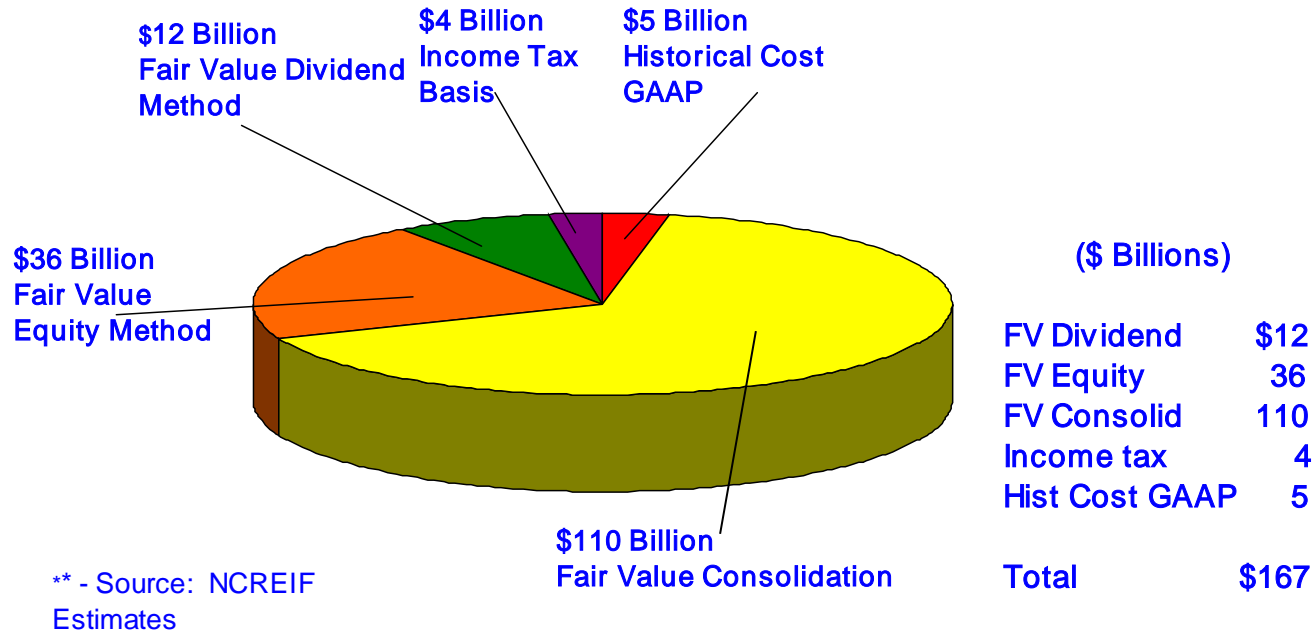
REITS	400
Public Non Exchange Traded Funds	<u>41</u>
	<u>441</u>

Total Equity	<u>\$1,259</u>
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- **\$1.3 trillion in US commercial real estate equity excludes corporate, government, non-profit as well as single family/owner-occupied residences**

* Source: *Emerging Trends in Real Estate 2009*, a publication of the Urban Land Institute & PricewaterhouseCoopers LLP

US Pension Real Estate Accounting Practices by Net Assets **



US Real Estate Accounting Practices

Fair value Dividend Method

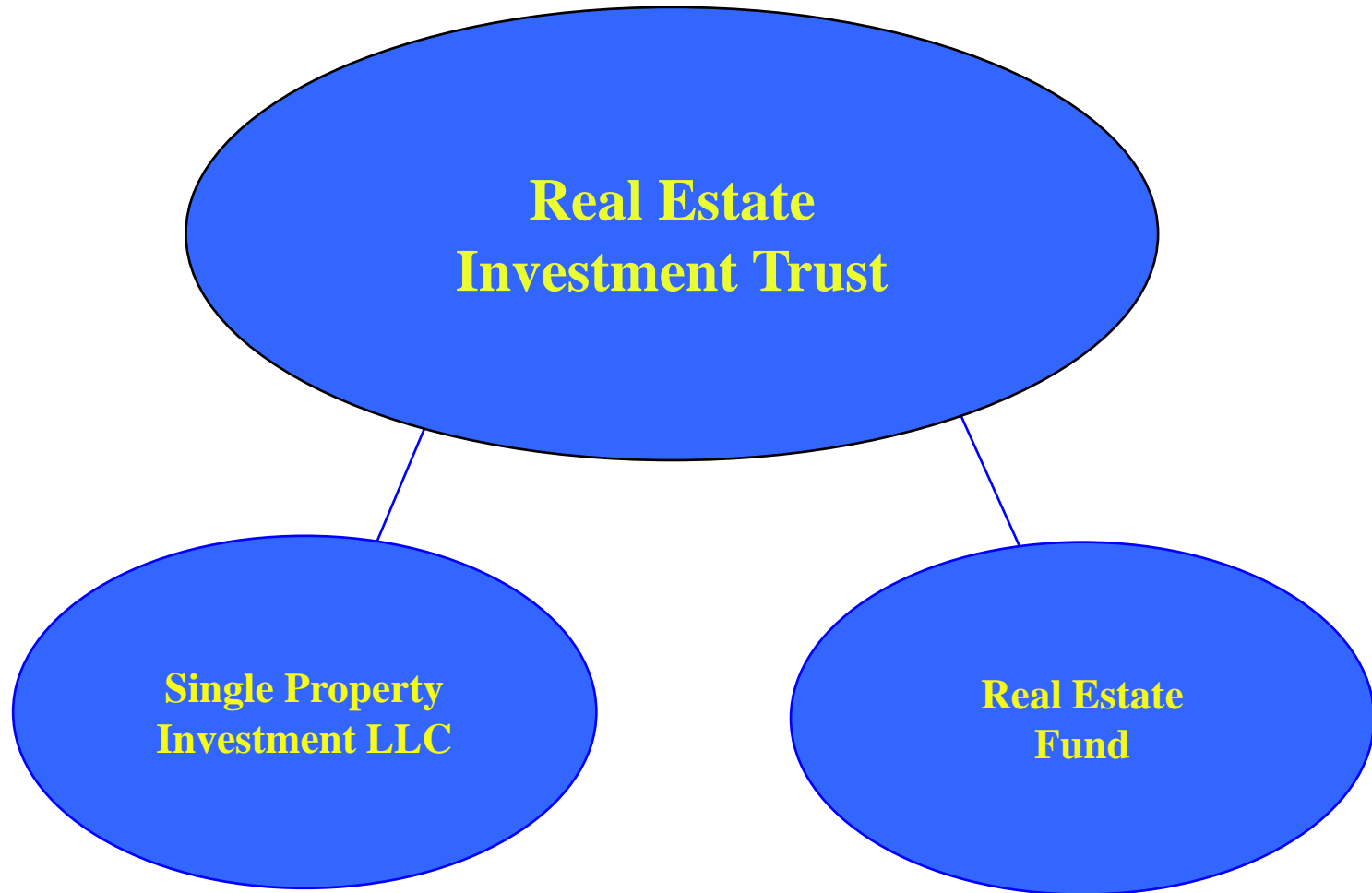
Fair value Equity Method

Fair value Consolidation Method

Income Tax Accounting

Historical Cost Accounting

Which RE Entities Can Mark to Market?



Pension Real Estate and Real Estate Investment Companies

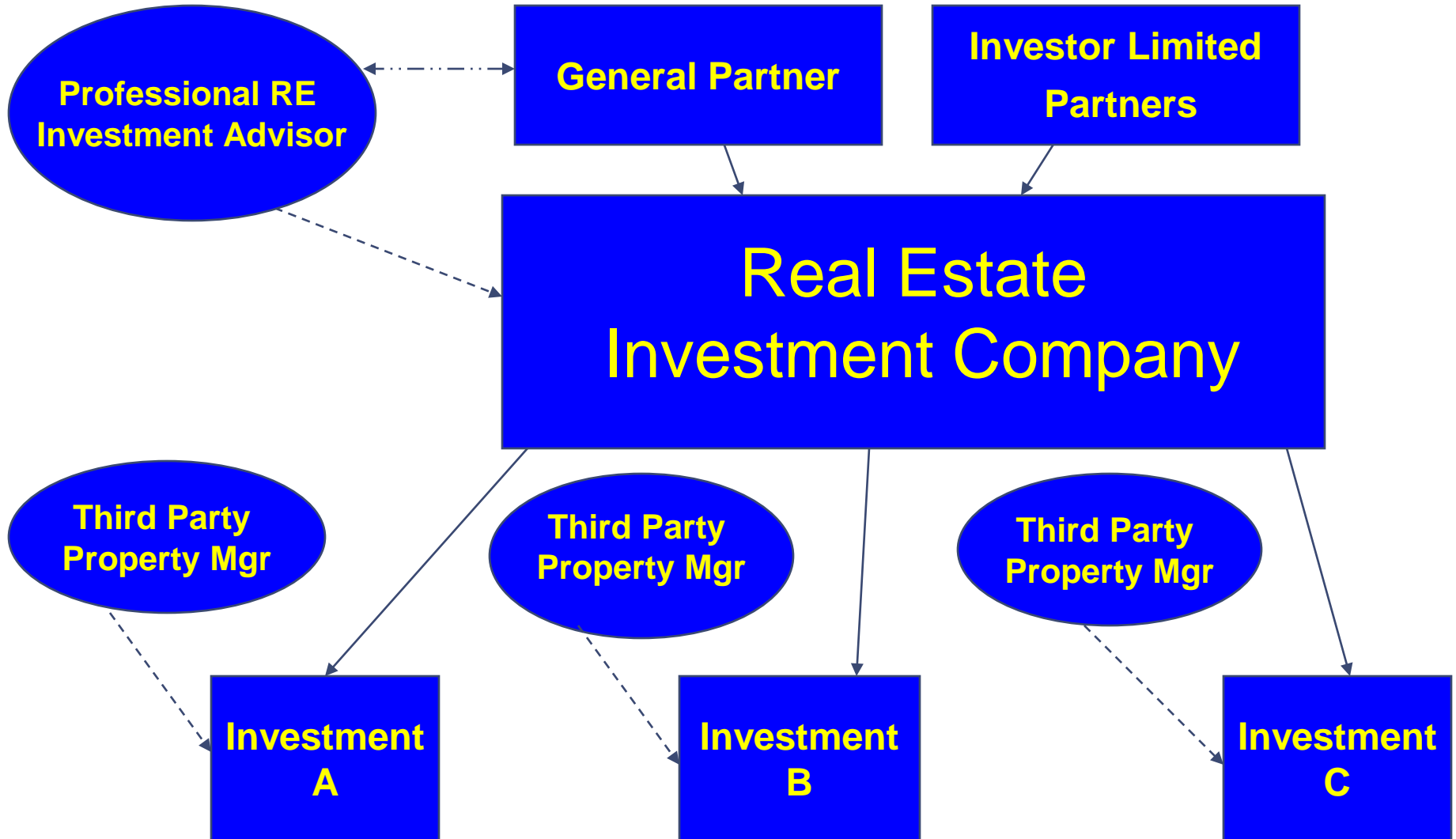
Pension plans are required to carry investments at fair value under US GAAP

Investments companies are required to carry investments at fair value under US GAAP

Attributes of investment companies

- a. Investment activity
- b. Unit ownership
- c. Pooling of funds
- d. Reporting entity

Common Real Estate Fund Structure



AICPA Real Estate Funds Project

Goal to provide guidance for RE funds applying IC Guide (ASC 946)

Task force conclusions drafted in the form of Q&A

Cleared Q&A – draft Technical Practice Aid at September 24, 2008 AcSEC meeting, subject to FASB consideration of authoritative action

General conclusion re: Fair Value Dividend Method

EITF 09-D Project

Application of the AICPA Audit and Accounting Guide Investment Companies by Real Estate Investment Companies

- Lack of clear accounting guidance for real estate investment entities
- Resulted in diversity in industry accounting practices
- AICPA project expected to provide clearer guidance but unable to provide for effective date and transition

Comparable Reporting of Income Yield

- EITF 09-D is about reporting comparable information for investment decisions
- Investment companies make investments for the purpose of generating income, appreciation, or both
- A higher expectation for income from an investment can be perceived by investors to equate to a lower risk of not achieving the expected total return
- Accordingly, income yields are one factor considered by investors when making investment decisions and investment allocations

Can an entity not within the scope of the Guide carry non-financial assets (real estate) at fair value?

- **View A** - If not applying the Guide or other authoritative GAAP, cannot carry real estate investments at fair value unless authorized by current GAAP other than category (d) GAAP
- Proponents of this view agree that reporting real estate investments at fair value is useful information to investors but don't believe it provides a basis for circumventing GAAP

Can an entity not within the scope of the Guide carry non-financial assets (real estate) at fair value?

- **View B** - If not applying the Guide or other authoritative GAAP, an entity may carry real estate investment at fair value if supported by prevalent industry practices
- Proponents of this view believe that precluding this practice would adversely impact investors' ability to compare entities with the real estate investment industry

Please share your view

Should an entity not within the scope of the Guide (ASC 946) be able to carry real estate investments at fair value without support from other authoritative GAAP?

- **View A** - If not applying the Guide or other authoritative GAAP, cannot carry real estate investments at fair value unless authorized by current GAAP other than category (d) GAAP
- **View B** - If not applying the Guide or other authoritative GAAP, an entity may carry real estate investment at fair value if supported by prevalent industry practices

Reporting Net Investment Income (NII) by a Real Estate Investment Company

How should a real estate investment company report NII?

- **View A** - An entity should report NII based on distributions of earnings received from investments
- Proponents of View A believe it is consistent with the requirements of the Guide (ASC 946)

Reporting Net Investment Income (NII) by a Real Estate Investment Company

How should a real estate investment company report NII?

- **View B** - An entity should report NII based on its share of earnings of the investee if it has significant influence or control over the investee
- Proponents of View B believe NII should not be dependent on the timing of distributions received and excluding depreciation and amortization is prudent because it results in information that is more relevant to investors

Please share your view

How should a real estate investment company report net investment income when carrying real estate investments at fair value?

- **View A** - An entity should report net investment income based on distributions of earnings received from investments
- **View B** - An entity should report net investment income based on its proportionate share of earnings of the investee if it has significant influence or control over the investee

Reporting Fee Simple Investments

How should a real estate investment company report investments owned in fee simple?

- **View A** - Fee simple investments should be reported in a manner consistent with other real estate investments. The form of the ownership should not impact the reporting or measurement of the investment results
- Proponents of View A believe it is important to report and measure all investments held in a consistent and comparable manner

Reporting Fee Simple Investments

How should a real estate investment company report investments owned in fee simple?

- **View B** - If an investment company owns fee simple investments, all the reporting and measurement criteria of authoritative GAAP should be applied for purposes of measuring cost, income, and appreciation
- Proponents of View B believe the fee simple investment is an asset of the entity, and therefore believe all authoritative GAAP applies for purposes of measuring the cost basis, net investment income, and realized/unrealized gain/loss on such investment

Please share your view

How should a real estate investment company report fee simple investments?

- **View A** - Fee simple investments should be reported in a manner consistent with other real estate investments. The form of the ownership should not impact the reporting or measurement of the investment
- **View B** - If an entity owns fee simple investments, all the reporting and measurement criteria of authoritative GAAP should be applied for purposes of measuring the cost basis, net investment income, and realized/unrealized gain/loss on such investment

Expected timing of the EITF 09-D project

- The decision to add this issue to the EITF agenda was made at the February 12, 2009 FASB Administrative meeting
- Staff anticipates the creation of a working group to assist the EITF
- General conditions for acceptance of EITF agenda items require the ability to complete the issue within one year

Real Estate Fair Value Measurements

- GAAP guidance for measuring FV dispersed and inconsistent
- Various myths & beliefs existed re: fair value principles
- FAS 157 (ASC 820) provides single definition of fair value
- Establishes a framework for measuring fair value
- Enhances disclosures about fair value measures
- Improves reporting related to quality of earnings

Basic Principles -Definition of Fair Value in FAS 157

*“Fair value is the price that would be received to **sell an asset** or paid to **transfer a liability** in an **orderly transaction** between **market participants** at the measurement date.”*

- Exit price – not an entry price
- Orderly transaction – not a forced liquidation
- Market participants – willing to transact, but not forced to transact

Basic Principles – Valuation Techniques

FAS 157 provides guidance on valuation techniques to be used for initial and subsequent measurement and describes three techniques:

- Market Approach
- Income Approach, and
- Cost Approach

Basic Principles – Market Participants

FAS 157 (ASC 820) emphasizes that fair value measurements should be based on the assumptions of market participants.

Market participants are buyers or sellers in the principal (or most advantageous) market for the asset or liability, that are:

- Independent of the reporting entity;
- Knowledgeable;
- Able to transact for the asset or liability;
- Willing to transact for the asset or liability; and
- May be hypothetical.

Basic Principles – Highest and Best vs. Intended Use

- Fair value measures are determined based on the use of the asset by a market participant, even if the intended use of the asset by the reporting entity may be different.
- Accordingly, management's intent may be irrelevant unless is indicative of market participants assumptions.

Basic Principles – Transaction Costs

- FAS 157 clarifies that the reporting entity's acquisition and/or disposition costs relating to an asset are **NOT** included in the asset's fair value estimate.
- Such costs are incremental to purchase or sell an asset and therefore are not an attribute of the asset.
- A standard DCF model is prepared from the perspective of the buyer and properly includes the buyer's disposition costs in the final year reversion amount as it is relevant in estimating what the buyer would be willing to pay for the asset.

Fair Value Framework - Unit of Account

- Represents what is being measured at FV
- Unit of Account is dependent on other authoritative GAAP
- Diversity in industry accounting practices for real estate funds has caused notable differences in the unit of account determination

FSP FAS 157-4

April 2009

FASB issued FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (FSP 157-4)

- Step 1: Assess factors to determine if the market has become inactive (i.e., there has been a significant decline in volume/activity compared to normal levels)
- Step 2: If market is inactive, perform additional analysis as the transaction price may not represent FV

Accounting Standards Update No. 2009-05 August 2009

- ASU 2009-05 is the final standard emanating from the feedback the FASB received on its exposure draft, proposed FSP FAS 157-f, Measuring Liabilities under FAS157
1. A valuation technique that uses the quoted price of the identical liability when traded as an asset or quoted prices for similar liabilities or similar liabilities when traded as assets
 2. Another valuation technique consistent with the principles of Topic 820, such as an income approach or a market approach

2009 Developments

Proposed FSP FAS 157-g

Estimating the Fair Value of Investments in Investment Companies That Have Calculated Net Asset Value per Share in Accordance with the AICPA Audit and Accounting Guide, Investment Companies

- Would be effective for periods ending after December 15, 2009, with early adoption permitted.
- *Permits* (does not require) use of NAV if determined in accordance with Investment Company Audit Guide as “practical expedient”

Provides for additional disclosures by major category

- Terms and conditions for redemptions
- If non-redeemable, estimated remaining life, timing of distributions
- Additional capital commitments, if any
- If redeemable fund, disclose redemption terms and restrictions (lock-up, gate), and best estimate of when restrictions would lapse

Proposed Accounting Standards Update

Improving Disclosures about Fair Value Measurements

Issued: August 28, 2009

Comment Deadline: October 12, 2009

1. Effect of reasonably possible alternative Level 3 inputs and the total effect(s) of the changes on the fair value measurement.
2. Disclosures about inputs and valuation techniques that fall in either Level 2 or Level 3.
3. Transfers in and/or out of Levels 1 and 2 and the reasons for the transfers.
4. Activity in Level 3 fair value measurements would be required on a gross basis rather than as one net number.

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