Valuation for Financial Reporting

Hot topics impacting the real estate industry

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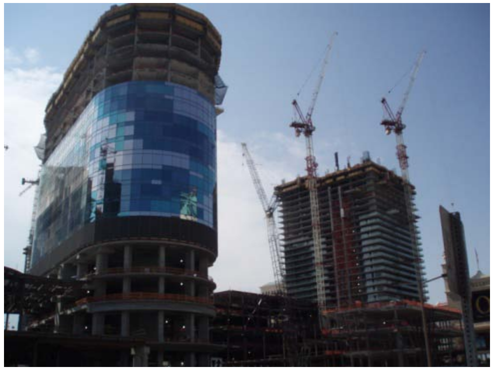
Cosmo

2007

2008



2009

2011

Overview

- Financial reporting, and thus VFR, continues to change
  - Numerous regulatory bodies
    - FASB
    - IASB (convergence)
    - SEC
    - Other regulations (i.e. Dodd Frank)
    - AICPA standards
- Impact to fair value of real estate must be understood

Financial Reporting Standard

Codification

- Statements of Financial Accounting Standards (SFAS) reorganized via Accounting Standards Codification (ASC)
- Effective for periods ending after September 15, 2009
- ASC is the single source of authoritative generally accepted accounting principles (GAAP) in the United States.
- The Codification is organized by topic, subtopic, section, and paragraph, each of which is identified by a numerical designation.

Standard	Formerly	Current
Fair Value	SFAS 157	ASC 820
Business Combinations	SFAS 141R	ASC 805
Goodwill Impairment	SFAS 142	ASC 350
Impairment of Long-Lived Assets	SFAS 144	ASC 360

- Need to update references in accounting policies, manuals, footnotes and other documents
- No requirement to cite the specific guidance in accounting footnotes

ASC 820 – Fair Value Standard

- Fair Value standard --- formerly known as SFAS 157
- Impacts:
  - Investments carried at Fair Value by real estate investment companies
  - Certain assets and liabilities measured at fair value in a business combination under ASC 805
  - Assets measured at fair value for an impairment test under ASC 350 and ASC 360
- Provides guidance on:
  - Definition of fair value
  - How to measure fair value
  - Highest & best use
  - Disclosures regarding measurements

ASC 820 – Fair Value (Cont'd)

- "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."
- Transaction price = entry price; fair value = exit price
- In many transactions, transaction price may be fair value
- Introduces concept of highest & best use to VFR
  - Assumes Highest and Best Use by Market Participants
  - ASC 820 criteria for highest and best use is consistent with conventional real estate appraisal methodology

ASC 820 – Fair Value

- Premise of Value
  - *In-use* – maximum value is derived from the operation of an asset in combination with other assets *as a group*
  - *In-exchange* – maximum value is derived from the operation of an asset on a standalone basis

- Measurement (Valuation) techniques
  - Income Approach (direct cap and DCF)
  - Sales Comparison (Market) Approach
  - Cost Approach
  - Techniques for VFR are consistent with conventional RE valuation techniques

- Transaction Costs

ASC 820 – Fair Value

- Fair Value Hierarchy --- 3 levels
  - Purpose is to maximize use of “observable” inputs (regardless of technique used) and minimize use of “unobservable” inputs
  - *Observable inputs*: reflective of assumptions that market participants would use
  - *Unobservable inputs*: reflective of entity’s own assumptions (i.e. investment criteria); or, market-based assumptions but not readily observable

- Level 1 Inputs:
  - Quoted prices (unadjusted) for identical assets or liabilities in active markets
- Level 2 Inputs:
  - Observable market data other than level 1 inputs
  - Quoted prices for similar assets or liabilities in active (or inactive) markets
- Level 3 Inputs:
  - Unobservable inputs
  - Inputs derived through extrapolation or interpolation that cannot be corroborated by market data

ASC 820 – Fair Value (Cont'd)

- *Accounting Standard Update (ASU)* was issued May 12, 2011
  - This is a converged standard; the IASB also issued IFRS 13
- Primary objective is to align the words in US GAAP and IFRS
- Secondary objectives:
  - Clarify and refine the measurement principles in Topic 820; and
  - Expand the fair value disclosure requirements for Level 3:
    - quantitative information about inputs
    - description of the valuation process used by the entity
    - narrative description of the sensitivity and any related interrelationships (this disclosure is not required for non-public entities)
- The ASU does not change:
  - When fair value measurements are required or permitted
  - The fundamental fair value measurement principles
    - Exit price
    - Market participant viewpoint

Lease Accounting

Lease Accounting

- FASB proposed new accounting rules for leases

  – Lessees
    - Operating leases now capitalized as assets with a corresponding liability
    - Cost basis: depreciation of asset / amortization of liability

  – Lessors:
    - Scope is not finalized at this time

    - Currently involves the "Derecognition" model to account for leases:
      – Lessor records a receivable for the lease, plus a residual value

    - However, certain types of companies are "scoped out" of the lease model and can will instead use a fair value method to value the entire asset

Lease Accounting

- Adopted by both FASB and IASB, but in slightly different forms

- For FASB, one model scenario was ultimately considered
  - Lessors will use "derecognition" model, except for:
    - Short term leases
    - Investment properties measured under fair value

- For entities that favored current operating lease accounting, this is not a favorable decision
- Numerous valuation and allocation difficulties arise under this model
- The scope of the investment property project will therefore receive greater scrutiny, since many Lessors want to avoid this accounting by measuring the asset at fair value

Investment Properties Project

FASB Investment Properties Project

- Convergence
- FASB asked "How does IFRS define Investment Property?"
- IASB has scoped investment property lessors out of the leasing project
- IAS 40
- Under this standard, determination is asset-based (i.e. What's an investment property?):
  - Held to earn rentals, capital appreciation, or both
  - Not for production of goods, services, or for administrative functions
  - Not for sale in the ordinary course of business (homebuilders)
  - Owners of hotels and healthcare properties
    - IAS 40.12 - If ancillary services provided to tenants are **significant**, you are deemed to have owner-occupied property, *not* investment property
- IAS 40 entities are therefore exempt from the new leasing requirements

FASB Investment Properties Project (cont'd)

- FASB's conclusion was different:
  - Scope will be entity-based, not asset-based like IAS 40
  - “Investment Property Entities” own investment property
  - Modeled off the current definition of an investment company
  - If entity meets requirements of an investment company, they measure their properties at fair value (eliminating need for lease accounting lessor rules)
- Objections from non-investment companies
- Out for public comment late 2011, likely effective date in 2015

FASB: Investment Properties Project (cont'd)

- Tentative definition of an investment property entity:
  a) Business Activities
     - Substantive activities relate to investing in real estate properties
  b) Business Purpose
     - The express business purpose is primarily investing in real estate properties for total return including capital appreciation, and the entity has identified potential exit strategies
  c) Unit Ownership
     - Ownership in the entity is represented by units of investments, such as shares or partnerships interests
  d) Pooling of Funds
     - One or more unrelated investors that hold significant ownership interests
  e) Reporting Entity
     - The entity can be a legal entity, but not necessarily (e.g. separate accounts)

FASB Investment Properties Project (cont'd)

- An investment property entity does not primarily hold real estate properties for any of the following purposes:
  - Use in the production or supply of goods or services or for administrative purpose
  - Sale in the ordinary course of business (i.e. homebuilders)
- Must evaluate the significance of an entity's operations that are not related to the operations expected from "investment property entities"
  - If non-investment property operations are significant, you are not an "investment property entity"

FASB Investment Properties Project (cont'd)

- Are investment property purchases business combinations?
  - Do you book lease intangibles if on a fair value model?
  - Do you expense acquisition costs (per SFAS 141R) or capitalize (per AICPA Investment Companies Guide)?
- Attitudes towards fair value are mixed
  - Industry enthusiasm seems to ebb and flow with the real estate cycles
  - Are you willing to accept a fair value requirement in exchange for being scoped out of the lessor accounting within the leases project?

Investment Companies

Investment Companies

- Joint project (FASB and IASB) to provide comprehensive guidance for assessing whether an entity is an investment company
- Will amend definition, provide measurement requirements and additional disclosures
- Exposure draft expected shortly (in conjunction with the investment property exposure draft)
- Convergence project w IASB – IASB doesn't have an investment company standard
- *Here's the tricky part*: "Investment Company" is different than "Investment Property Entity" --- but very similar!

Investment Companies (cont'd)

Criteria	Current Guidance	Tentative Decisions
Express business purpose	Substantively addressed through investment activity criteria	The express business purpose of an investment company is investing for current income, capital appreciation, or both
Investment activity	Primary business activity involves investing its assets, usually in securities of other entities not under common management, for current income, appreciation, or both	Substantially all of the entity's activities are investment activities carried out for the purposes of generating current income, capital appreciation, or both. The entity and its affiliates shall not obtain benefits from its investees that would be unavailable to other investors or unrelated parties of the investee
Exit strategy	Not specifically addressed in criteria	The entity has identified potential exit strategies and a defined time (or range of dates) at which it expects to exit the investment
Unit ownership	Ownership in the investment company is represented by units of investments, such as shares of stock or partnership interests, to which proportionate shares of net assets can be attributed	Ownership in the entity is represented by units of investment
Pooling of funds	The funds of the investment company's owners are pooled to avail owners of professional investment management	The funds of the entity's owners are pooled to avail owners of professional investment management
Fair value	Not specifically addressed as criteria	All of the investments are managed, and their performance evaluated (both internally and externally), on a fair value basis
Reporting entity	The investment company is the primary reporting entity	The entity must be a reporting entity

Investment Companies (cont'd)

<u>Interaction with Investment Property Entities</u>

- Tentative decisions:
- *Lots of overlap between the two definitions*
  - If you are both an *investment company* and an *investment property entity*:
    - Apply the investment property entity accounting guidance
  - If you are an investment company with investments in real estate property (but *not* an investment property entity)
    - Apply the investment property entity presentation and disclosure requirements for all material investments in real estate property
      - Rental income and rental expenses (new)
      - Fair value of investment properties and debt (new)
- The FASB believes that similar disclosure requirements for investments in real estate, for both investment property entities and investment company entities, will minimize the tension regarding the overlap between the two standards

Dodd Frank Act

Dodd-Frank Act

Dodd-Frank Wall Street Reform and Consumer Protection Act

- Banks
  - – Tightens capital requirements and lending standards
    - Will this reduce lending?
  - – Limits banks’ involvement in RE fund raising activities
    - Will this cause banks to exit this market? (i.e. Citi sale of fund business to PE firm Apollo in late 2010)

- CMBS Market
  - – Requires issuers to retain 5% stake in the securitization
  - – Imposes new disclosure requirements
  - – Imposes stricter standards on the rating agencies when rating securitizations

- Real Estate Advisors
  - – Must register with SEC
  - – Must disclose relationships with appraisers/reviewers to avoid conflicts of interest
  - – Must enact internal controls to ensure independence/objectivity (e.g. for valuations)