



NATIONAL
ASSOCIATION
OF
REAL ESTATE
INVESTMENT
TRUSTS®

April 23, 2001

Mr. Marc Simon
Technical Manager, Accounting Standards
File 4210.VE
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Re: Proposed Statement of Position – Accounting for Investors’ Interests in
Unconsolidated Real Estate Investments

Dear Mr. Simon:

The National Association of Real Estate Investment Trusts (NAREIT) is pleased to have the opportunity to respond to the American Institute of Certified Public Accountants’ (AICPA) Exposure Draft (ED) of the proposed policy on unconsolidated real estate investments. NAREIT is the national trade association for real estate investment trusts (REITs) and other publicly traded real estate companies. Members include REITs and other businesses that develop, own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service these businesses.

The business of developing, owning and operating income-producing property regularly and increasingly involves the use of joint ventures. In this context, the accounting standards for unconsolidated ventures are important to producing useful financial reports for publicly traded real estate companies.

General Comments

Complexity and Scope

The proposed SOP would result in dramatic changes in accounting for unconsolidated investments. Substantive changes to accounting guidance in APB No. 18 and related EITF conclusions include:

- ?? Eliminating the “ownership level” method of measuring the earnings impacts of investments in unconsolidated investments – explicitly provided for in both APB 18 and EITF 99-10;
- ?? Introducing the complex hypothetical liquidation at book value (HLBV) method of measuring an investor’s claim on the net assets of an investee; and
- ?? Providing that Statement 115 takes precedence over APB No. 18 – inconsistent with APB 18 and EITF 98-13.

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In addition, applying this new complex accounting solely to real estate would, at best, only marginally enhance the usefulness of the industry's financial reporting. This is due to the economic characteristics of real estate assets and operations, as more fully explained below under *Divergence from Economic Reality*. We believe this new accounting for unconsolidated investments would be more relevant to most other industries.

We strongly believe that such dramatic and complex changes in accounting should not be applied only to one industry. Nor do we believe they should be promulgated in the form of an AICPA Statement of Position (SOP). We, therefore, respectfully request that this SOP not be issued and that universally applicable standards for accounting for interests in unconsolidated investments be considered as a Financial Accounting Standards Board (FASB) project. It seems to us that the kind of guidance provided in the proposed SOP may be more appropriately dealt with in the context of the Board's Business Combinations/New Basis Accounting project.

Divergence from Economic Reality

Does the SOP result in financial reporting that faithfully represents the economic impacts of investors' interests in unconsolidated real estate investments? We believe that the SOP implicitly promises a result that it does not and cannot deliver – especially for real estate companies. The hypothetical liquidation method of measuring an investor's claim on the net assets of an investee may be conceptually sound. However, the added complexity does not outweigh the marginal enhancement and usefulness of the equity method of accounting for real estate companies because of the **HLBV** method's reliance on historical cost book value. Measuring an investor's claim on the GAAP, historical cost book value of a real estate investee falls far short of reflecting the real value of such claim and changes in that claim.

For example, since GAAP depreciation is normally greater than principal payments on the mortgage debt secured by a property, the GAAP carrying value of the property will, in many cases, fall short of the outstanding principal balance of the mortgage – a shortfall that will increase year after year. Therefore, at least part of the GAAP operating results accruable to the equity owners will be absorbed by this shortfall in all accounting periods.

This divergence with economic reality is exacerbated when the mortgage provides the lender with a share of appreciation in the property. Under SOP 97-1, *Accounting by Participating Loan Borrowers*, the investee/borrower will accrue the lender's share of the property's appreciation as an operating expense and a liability. While this liability is created by real appreciation in the property, the HLBV approach does not allow the investor to assume appreciation in the property. Thus, this liability will need to be "covered" by the investee's cost basis of assets and earnings.

Example 4 produces a result that may be far from economic reality and further distorts the financial reporting for investment real estate. Co. A's recognized loss of \$2,000 implies

that its note receivable from Investee I is worth only \$3,000. Why should this be reported when there has been no evaluation of the note's real value/impairment?

Finally, a simple example of the divergence of the proposed SOP from the economic reality of measuring an investor's claim on the book value of an investee can be illustrated by using the ED's Example 5. If the fair value were used to measure the carrying amount of the property, Co. A's claim on the net assets of Investee I would be \$27,000 at 12/31/X1 – an increase of \$21,000 during the year. This would represent the real economic income to Co. A. The \$500 impact on Co. A's earnings illustrated in the example is dramatically unrealistic – if not misleading.

For each of the cases described above, using the fair value of the investee's assets and liabilities or, alternatively, after eliminating the investee's accumulated depreciation balance, would produce financial reporting that more faithfully represents the economic impacts of interests in unconsolidated real estate investments.

Conclusion

In many instances, the SOP states and acknowledges that the "measurement of fair value is the most relevant" and "what is relevant to the investor is the fair value of the investee's assets and liabilities at the time it makes its investment, not the book value of those assets and liabilities." We agree with these conclusions. Further, many financial statement consumers would agree that historical cost balance sheets of real estate companies do not reflect the real economic financial position of these companies. Measuring an investor's claims based on the historical cost basis of the net assets of a real estate investee does not produce a faithful representation of the economics of that claim.

To promulgate an accounting standard specifically applicable to real estate that is mired in historical cost accounting, while at the same time acknowledging the superior relevance of fair value measurements, creates complexities that result in only marginal enhancements and potentially misleading reporting for interests in unconsolidated real estate investments.

As you are aware, the FASB has initiated a rulemaking effort related to "new basis" accounting for joint ventures and other combinations. This effort would apply to the accounting for formation transactions in all industries. We believe that the SOP should not be issued because it does not measure the actual economics of an investor's claim on the net assets of a real estate investee, and is not applicable to investors' interests in unconsolidated investments in all industries.

If the AICPA proceeds with this proposed SOP, we urge the AICPA to provide for measuring the assets and liabilities of real estate investees on the basis of fair value in calculating the investor's claim on the investee's net assets. Alternatively, the calculation should be made after the elimination of the real estate investee's accumulated depreciation balance.

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In the event the AICPA decides to proceed with the proposed SOP, the following are NAREIT's comments related to *Contributions of Real Estate* and the *Areas Requiring Particular Attention by Respondents*.

Contributions of Real Estate

Paragraph 71 of the ED indicates that, "an investor that contributes capital in the form of real estate to an investee should not recognize any gain upon the contribution ...". Based on paragraphs 65, 66 and 73, the SOP should clarify that transfers of property to a joint venture that are structured as sales should result in recognition of gain to the extent of other interests in the investee.

Areas Requiring Particular Attention by Respondents

Issue 1:

In paragraph A1 of Appendix A, *Basis for Conclusions*, the Accounting Standards Executive Committee (AcSEC) states that because it "believes that the FASB No. 115 measurement attribute of fair value is the most relevant, AcSEC decided that FASB Statement No. 115 should take precedence over the equity method for investments in nonvoting common stock or nonredeemable preferred stock." This is contrary to APB 18, EITF 98-13 and SFAS No. 115. Our reading of Statement No. 115 would lead us to conclude that this Statement does not apply to equity investments accounted for under the equity method. Whether or not the securities have a readily determinable fair value should not preclude it from being accounted for under the equity method. We believe that allowing Statement No. 115 to take precedence simply because of its fair value attribute, is inconsistent with the proposed SOP's reliance on historical cost measurements. If fair value measurements are most relevant to accounting for interests in unconsolidated investments, and we believe they are, fair value should be used to address the issues raised earlier in this letter regarding the divergence of results in applying the SOP to real estate as compared to the real economics of an investor's claim on an investee's net assets.

Issue 2:

We are concerned about the inconsistency in AcSEC's conclusion with respect to this issue compared with APB 18 which states that potential voting privileges should be disregarded in determining an investor's ownership interest or whether the investor has significant influence over the investee. The proposed SOP indicates that an investor's ability to appoint 20% of the board of directors leads to a presumption that an investor has the ability to exercise significant influence over the investee. We believe that paragraph 9 of the SOP should require that the investor have actually appointed 20% of the board of directors.

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Issue 3:

We agree with AcSEC's conclusion that the equity method of accounting should be used by investors in noncorporate unconsolidated investees when the investor has the ability to exercise significant influence over the investee.

Issue 4:

NAREIT disagrees with AcSEC's conclusion on this issue. The existence of a specific ownership account, such as an individual capital account in a large public limited partnership syndication, should not determine whether an investor should apply the equity method. The economics of owning a limited partnership interest in a public syndication is identical to that of a common stock investment and should be treated the same way. If there is no significant influence, we believe that it is inappropriate for the investor to account for its investment using the equity method.

We agree that S corporations and REITs should not be considered specific ownership account entities for the purpose of the proposed SOP.

Issue 5:

The information necessary to apply the equity method is not likely to be available when the investor does not exert significant influence. This would be especially true for minimal ownership interests in specific ownership account-like structures (see Issue 4). In many cases these investors may only receive Form K-1 once a year for tax purposes. For these passive equity investments, the cost method and accounting standards focused on investment impairment should apply. When the investor truly can exert significant influence, they should be able to obtain the information necessary to do the calculations required under the equity method for investees subject to public reporting requirements. However, many non-public companies may not provide quarterly balance sheets, or may not provide them on a timely basis.

Issue 6:

Earlier in this comment letter we shared our views on the HLBV method. In summary, we believe that a hypothetical liquidation approach is conceptually sound. However, because of the **HLBV**'s reliance on historical cost book value, it only marginally enhances the usefulness of the equity method of accounting for real estate companies. We do not believe that the benefits of this approach outweigh the complexities and cost of its implementation. As stated above, if the AICPA proceeds with this proposed SOP, we urge that the SOP provide for the measurement of the assets and liabilities of real estate investees on the basis of fair value in calculating the investor's claim on the investee's net assets. Alternatively, the calculation should be made after the elimination of the real estate investee's accumulated depreciation balance.

In addition to the problems raised above, we strongly disagree with the conclusion reached in paragraph 20. This is inconsistent with our experience. We would appreciate AcSEC

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sharing any evidence that investor-creditors generally subordinate their creditor interest to noninvestor-creditors in the same priority class.

Issue 7:

We believe that the AICPA should more fully explore the concept of “otherwise committed” as part of this project. NAREIT believes that this concept encompasses instances when an investor, although without the legal obligation to do so, intends to fully support and fund the operations of the venture and, therefore, should recognize losses in excess of its capital account. Since there is no legal obligation to fund, further guidance is necessary to insure consistency in practice as to classifying an investor as either committed or uncommitted to provide further financial support to an investee. In most instances, the classification of an investor as committed would be determined at the inception of the venture. However, events or changes in circumstances may cause the classification of an investor to change. Examples of such instances include: (a) the expiration of a guarantee, obligation or unconditional commitment; (b) the reaching of a limit of a guarantee, obligation or unconditional commitment; (c) the modification of a venture agreement; or (d) a demonstrable change in managerial intent providing evidence of the termination of a constructive obligation or commitment.

With respect to the examples posed in the request for comment, the distribution of proceeds in excess of an uncommitted investor’s investment should lead to the recognition of income by that investor since there is no obligation under any circumstances for the investor to pay these “excess” proceeds back. AcSEC should affirmatively state that funds received by an uncommitted investor should not reduce their investment accounts in a venture below zero but should be recorded as income.

Issue 8:

We believe that this mechanism, which recognizes the difference between fair value and book value at the time of investing in an existing entity, is required in order for the HLBV method to have at least some relevance. At the same time, these methods add complexity to an already complex accounting treatment.

Issue 9:

We agree with the general guidance in the ED.

Issue 10:

We agree with the conclusions reached in paragraph 38.

Issue 11:

We believe that the conclusions reached in paragraphs 39 and 40 are consistent with the HLBV model.

Issue 12:

The measurement of the impact of individual elements of an investee's OCI on the earnings of an investor applying the HLBV method exacerbates the complexity of this approach. Again, we agree with the method conceptually, but are concerned about the complexity. We would suggest that AcSEC consider an alternative approach that would measure the investor's share of the aggregate OCI of the investee and include this as one amount in the Statement of Earnings of the investor. This would be more consistent with the one-line presentation required by the equity method to reflect the impact on the investor's operating results.

Issue 13:

As indicated in our general comments, we are concerned that the application of the HLBV approach will, in many cases, reflect an implicit write-down of a loan to an investee when there is no issue concerning the collectability or impairment of the loan. This is clear from Example 20. Even when an investor may hold a valid note receivable from an investee, applying the HLBV method may limit both the amount of income recognized on the loan by the investor as well as the loan's carrying value – all due to relying on the depreciated historical cost of the asset and earnings after depreciation. If not for the equity investment, the carrying amount of the loan and the related income recognized would be based on fair value and cash flow evaluations. We believe that valid loans held by an investor should be evaluated separately from applying the SOP to the investor's equity investment.

Issue 14:

Once again we raise the issue of unnecessary complexity. The method of determining the down payment requirement proposed in the ED introduces subjective measurements that will not result in enhanced financial reporting. In spite of the conclusions reached in EITF Issue 98-8, we believe that it would be appropriate to evaluate the adequacy of the down payment using the actual sales value of the interest being sold and the percentage down payment requirement associated with the type of property underlying the investment. In Example 23, the down payment requirement would be $\$600 = 10\%(\$2,800 + \$3,200)$. Using the actual sales value of the interest would certainly result in more reliable measurement than using the estimated value of the underlying real estate.

Issue 15:

We are concerned that the cumulative effects of applying this SOP could have a material negative impact on the equity of companies who are investors in many joint ventures. This impact could affect compliance with loan and other "net worth" covenants. In order to mitigate this impact, AcSEC should consider requiring companies to account for changes in claims on investees' net assets only subsequent to the adoption of the SOP. Otherwise, AcSEC should clarify that the calculation of the cumulative effect of applying the proposed SOP will be measured as the difference between the carrying amount of investments prior to adoption of the SOP and the investor's claim on the net assets of investees at the date of adoption.

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NAREIT appreciates the opportunity to participate in the AICPA's considerations with respect to accounting for unconsolidated real estate investments. If you should have any questions regarding this response, please contact the undersigned at (202) 739-9432, or David Taube, NAREIT's Director, Financial Standards at (202) 739-9442.

Sincerely,

George L. Yungmann
Vice President, Financial Standards
National Association of Real Estate Investment Trusts

cc: Lynn Turner, SEC, Office of Chief Accountant
Andrew Hubacher, SEC, Office of Chief Accountant
Timothy Lucas, FASB, Director of Research and Technical Activities
Barry Lefkowitz, Co-Chair, NAREIT Accounting Committee
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