cutting through complexity

How does the new investment company accounting literature apply to real estate entities?

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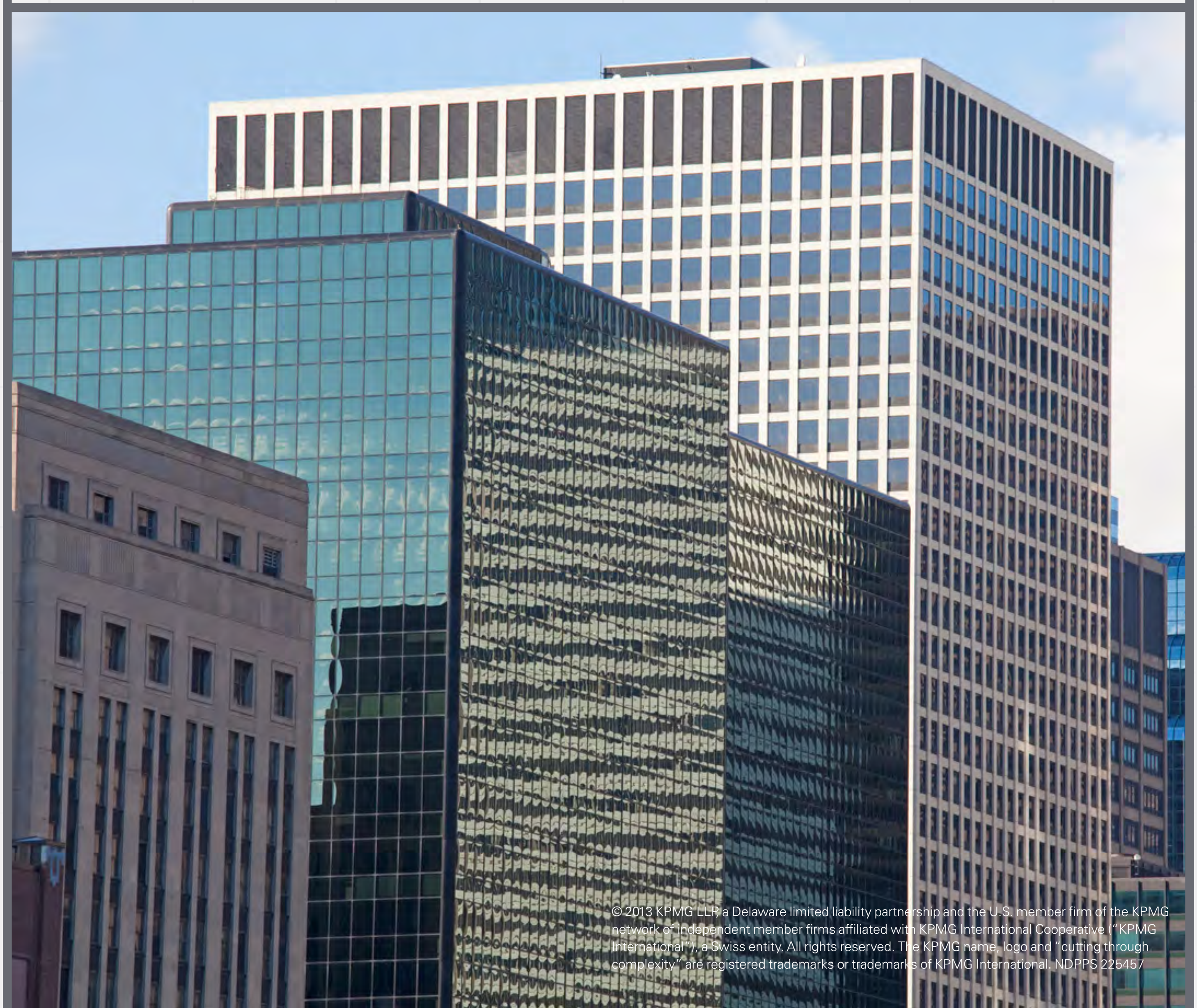
Introduction

The FASB has issued a new Accounting Standards Update (ASU) that will affect investment company accounting and disclosure requirements in the following ways:[1]

- Revise the criteria that define an investment company
- Clarify measurement guidance that applies to an investment company
- Require new disclosures.

This publication discusses the investment company accounting and disclosure requirements and how they impact real estate investment entities.

[1] Accounting Standards Update No. 2013-08, Financial Services – Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements, available at www.fasb.org.



Entities (except for REITs that do not apply investment company accounting and regulated investment companies) must reassess applicability of requirements

Consistent with current U.S. GAAP, real estate investment trusts (REITs) are specifically excluded from the scope of the investment company accounting and financial reporting requirements of U.S. GAAP. Entities regulated under the Investment Company Act of 1940 are automatically subject to those requirements. All other entities must reassess whether they possess specific fundamental (required) characteristics and consider other typical (but not required) characteristics to determine whether to apply the U.S. GAAP investment company accounting and financial reporting requirements. Reassessments must occur in time to apply the new guidance by its effective date—i.e., January 1, 2014 for entities with a calendar year-end.

During the proposal process, the FASB initially decided to remove the scope exception in Topic 946 for REITs because it was concerned that the exception was based on whether an entity has made a designation to be treated as a REIT under the Internal Revenue Code. A REIT owns, and in most cases, operates income-producing real estate.

However, many REIT stakeholders and their representative organizations disagreed with the decision to remove the scope exception, stating that the business model of REITs is different than that of investment companies. Because of the complexity of the issues and potential delay in issuing guidance for assessing investment company status for other types of entities, the FASB ultimately decided to retain the existing scope exception in Topic 946 for REITs.

The FASB indicated that it does not intend to change current accounting and financial reporting by real estate investment entities that are currently considered investment companies or for which it is industry practice to issue financial statements consistent with the measurement principles applicable to investment companies. Although the changes in the criteria that define an investment company may not cause a change in accounting and financial reporting practices for most real estate investment entities, all entities must perform a new assessment when the guidance becomes effective, including non-REIT entities that hold real estate.

What this means for real estate investment entities

Sometimes a nonpublic REIT is formed as a blocker entity or a feeder fund in a master-feeder structure. In those cases, the REIT may follow feeder fund accounting in accordance with ASC 946-210-45-6. Although the FASB stated it did not intend for real estate entities to change current accounting and financial reporting, this scenario does not appear to be clearly addressed, as REITs are scoped out of Topic 946. The FASB decided to address the applicability of investment company accounting to real estate entities (including REITs) more broadly in a separate project in the future.

Some real estate investment entities have measured their real estate investments at fair value using the Real Estate Information Standards' (REIS) operating model, which results in a gross presentation of investees' property and related debt for financial reporting purposes. These entities must consider whether they meet the definition of an investment company under the new standard. If so, they would need to consider the materiality of any differences between the financial reporting under the REIS operating model and investment company accounting and financial reporting. In some cases, investment company accounting and financial reporting may be more closely akin to the REIS' nonoperating model (for example, if debt is not measured at fair value under the operating model). Although the FASB stated it did not intend for real estate entities to change current accounting and financial reporting, this scenario also does not appear to be clearly addressed.

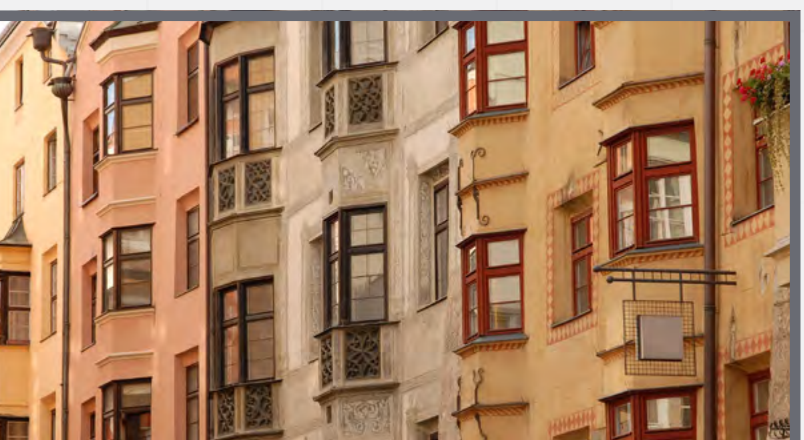
Investment company characteristics

Fundamental (required):

- Obtains funds from investors and provides them with investment management services
- Sole business purpose and substantive activities are investing funds for capital appreciation, investment income, or both
- Entity or its affiliates do not derive strategic or operating benefits from investments other than capital appreciation or investment income

An exit strategy is required for an investment company whose investment objectives include realizing returns from capital appreciation because the investment company must have a plan to dispose of its investments to realize the capital appreciation. An exit strategy is not required for investments held solely with the objective of receiving returns from investment income (e.g., some investments in municipal bonds).

An entity would not be an investment company if the entity or its affiliates obtain or have the objective of obtaining returns or benefits from an investee or its affiliate through operating or strategic activities. An investment company may be involved in day-to-day management activities of its investees and provide financial support to its investees if those services are provided to maximize the overall value or capital appreciation of the investment, and they do not represent a separate substantial business activity or separate substantial source of income for the investment company entity (or its affiliates in relation to the investing activities of the entity).



What this means for real estate investment entities

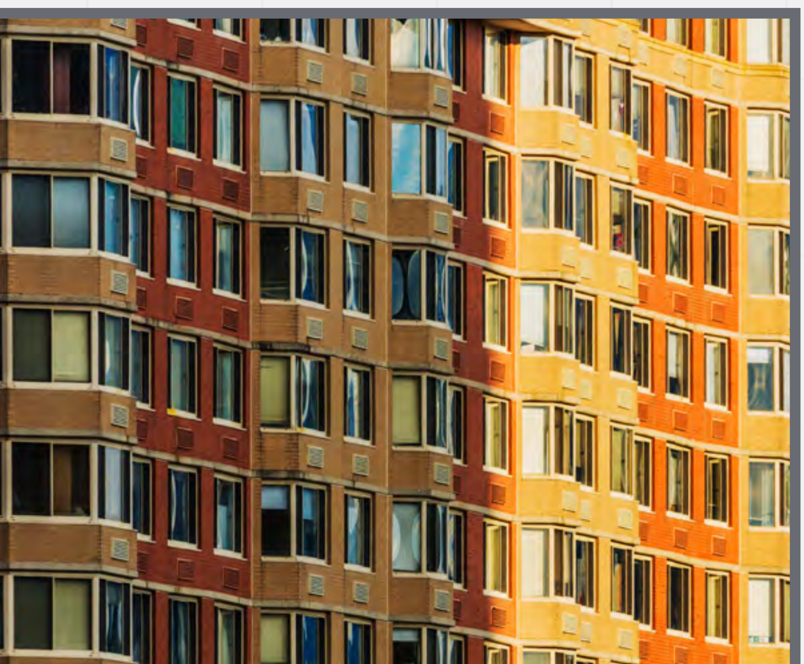
As an example, a real estate investment entity formed to own and operate retail properties acquires land for development through contribution of properties from the entity's general partner, who owns a 1 percent interest in the entity, with the remaining 99 percent interest held by unrelated investors. The properties are developed into retail centers by the general partner. After development, the properties are managed by the general partner. The general partner also develops, owns, and operates other retail properties. Although the transactions between the real estate investment entity and its general partner may be on terms that are available to entities that are not related parties of the investees, the investment company assessment would consider whether the affiliate's (the general partner's) activities of providing development and management of the retail properties represent a separate substantive business activity or separate source of income for the entity (or its affiliates in relation to the investment activities of the entity). If they do, then the entity would not meet the criteria to be an investment company.

Typical:

- Holds multiple investments
- Has multiple investors
- Investors include external or unrelated parties
- Ownership interests are equity or partnership interests
- Investments are managed on a fair value basis

The absence of one or more of the typical characteristics does not necessarily prevent an entity from being an investment company. If an entity does not possess one or more of the typical characteristics, the guidance allows for judgment and some flexibility in assessing whether the entity's business activities, considering all facts and circumstances, are consistent with those of an investment company.

An investment company typically manages substantially all of its investments on a fair value basis. The FASB recognized that fair value information is critical for analyzing performance of investments made by investment companies and that fair value management can be performed in a number of ways. For example, an entity may use fair value as the primary measurement attribute used to evaluate the financial performance of, and to make investment decisions for, substantially all of its investments. Alternatively, an entity may transact with its investors on the basis of net asset value per share, which is calculated using the fair value of the entity's investments, or some fees (e.g., management fees) may be calculated on the basis of the fair value of the entity's investments.



What this means for real estate investment entities

Although the new guidance requires a different analysis than current U.S. GAAP, given the limited fundamental characteristics and the judgmental nature of the typical characteristics, it is likely that most real estate investment entities considered investment companies under current U.S. GAAP will reach the same conclusion under the ASU's provisions about whether they qualify as an investment company.

For real estate investment entities that did not apply investment company accounting in the past, the flexibility in assessing whether the entity's business activities are consistent with those of an investment company may allow the entities to conclude that they meet the new investment company criteria. For example, certain real estate investment entities may not hold multiple investments. However, they may conclude that they qualify for investment company accounting even though they do not have all of the typical characteristics of an investment company. In applying the new standard, diversity in application is likely to arise in the evaluation of whether a real estate entity is an investment company if only a few of the typical characteristics are met.

Measurement, presentation, and disclosure

- An investment company must continue to measure its investments at fair value, as required by current U.S. GAAP.
- U.S. GAAP permits but does not require an investment company to consolidate another investment company in which it holds a controlling financial interest. There is no change to the guidance about whether an investment company should consolidate another investment company in which it holds a controlling financial interest.
- The new guidance clarifies that an investment company should not apply the equity method to account for a noncontrolling investment interest in another investment company—it should be measured at fair value. Usually it would be acceptable to determine fair value using the net asset value per share practical expedient in U.S. GAAP.
- There is no change to the requirement for a noninvestment company parent of an investment company to retain the investment company's accounting in the parent's U.S. GAAP consolidated financial statements.

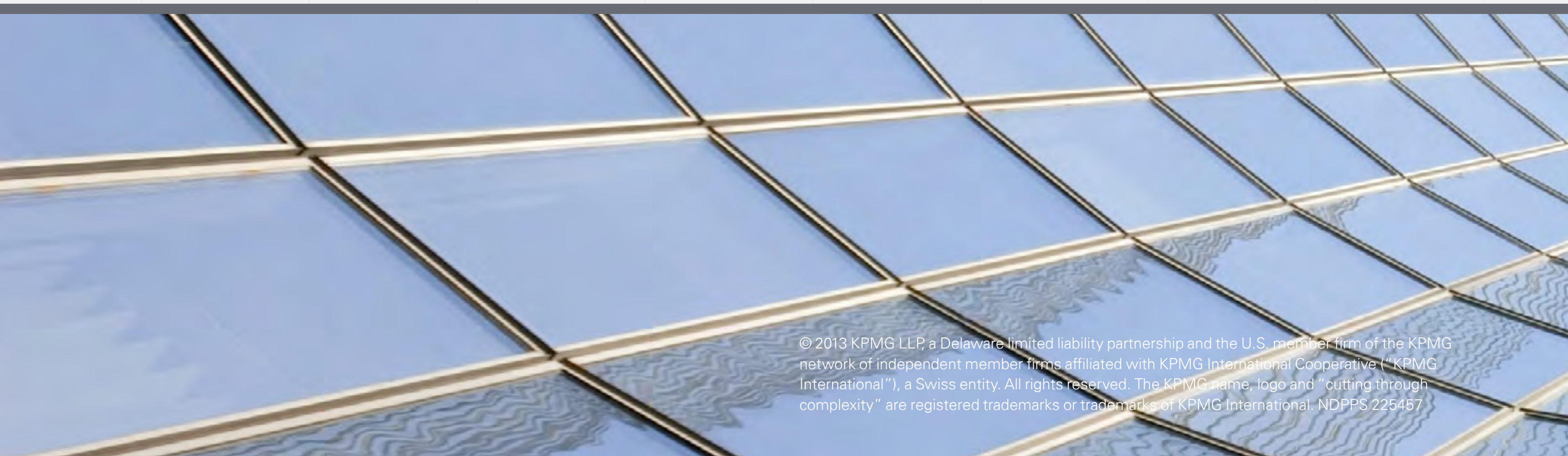
New disclosure requirements include:

- A statement that the entity is considered an investment company and is subject to the investment company accounting and financial reporting requirements in U.S. GAAP
- Information about changes in the entity's status as an investment company and the reasons for the change
- The type, amount, and primary reasons for financial support provided to investees or financial support that is contractually required to be provided. Information on financial support provided to investees is required to be disaggregated between what was contractually required and what was paid without being contractually obligated to do so.

What this means for real estate investment entities

While many real estate investment entities already include similar disclosures in their financial statements, these disclosures were not previously required under Topic 946. Real estate investment entities should consider whether their current disclosures address all of the new requirements.

Further, while major changes related to the accounting model applied for real estate investment entities is not expected, there appears to be some inconsistency in application in this area. Therefore, it will be important in situations where a group of real estate investment entities shares a common manager or adviser to ensure there is consistency in application across the group and with other managers or advisers under common control. We see a key outcome of this standard being a need to have documented accounting policies around the application of the investment company criteria and determination of which types of entities are considered investment companies.



Key differences with IFRS

Notable differences between IFRS and U.S. GAAP upon the effective date of the new guidance include the following:

- Financial statement presentation – IFRS does not contain the detailed financial statement presentation guidance for investment entities that U.S. GAAP does.
- Exit strategy requirement – IFRS requires investment entities to have an exit strategy for investments without stated maturity dates (e.g., equity securities and nonfinancial assets). U.S. GAAP only requires an investment company to have an exit strategy for investments held with the objective of realizing capital appreciation, but not for investments held solely with the objective of receiving returns from investment income.

What this means for real estate investment entities

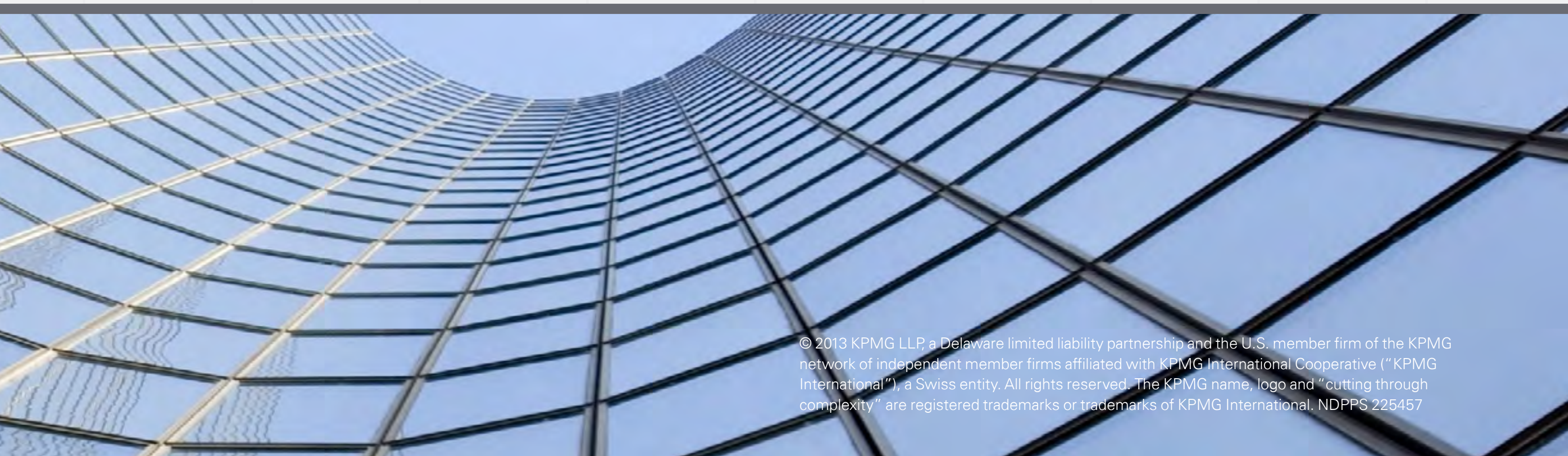
A difference arises when a real estate investment entity is investing for investment income only. These entities could be considered investment companies under U.S. GAAP but may not meet the criteria under IFRS.

- Managing on a fair value basis – IFRS requires an entity to measure (not manage) the performance of substantially all of its investments on a fair value basis to meet the criteria of an investment entity. Under U.S. GAAP, fair value management is a "typical" characteristic of an investment company.

What this means for real estate investment entities

A key difference is that while real estate investment entities may manage investments on a fair value basis and provide fair value measurement from time to time, if they do not measure substantially all of their investments at all times on a fair value basis, the real estate investment entity will not be an investment company under IFRS.

- Investing-related services – IFRS permits an investment company to provide investing-related services (e.g., investment advisory services and investment management) to third parties while U.S. GAAP specifically prohibits an investment company from providing these services directly or indirectly to third parties, unless these services are deemed to be nonsubstantive.
- Noninvestment company parent – IFRS requires a noninvestment entity parent to consolidate controlled investees of an investment entity subsidiary. U.S. GAAP requires a noninvestment company parent to retain an investment company subsidiary's accounting in the parent's consolidated financial statements.



Related developments

Investment companies and other investment entities may be impacted by the following future FASB projects.

Consolidation: Principal versus agent analysis

This project is expected to provide guidance on whether a decision maker should be considered a principal and be required to consolidate an entity to which it provides services or whether it is an agent that is not required to consolidate the entity. The project is also intended to eliminate inconsistencies in U.S. GAAP consolidation models (e.g., for variable interest entities and voting interest entities). The FASB currently expects to issue a final standard in 2014.

Investment companies: Disclosures about investments in another investment company

This FASB project is expected to address required disclosures in an investment company's financial statements that will provide transparency into the risks, obligations, and expenses of an investee that is also an investment company.

Investment properties

The FASB decided to discontinue development of proposed guidance that would have defined investment property entities (IPEs) and currently lists these efforts as an inactive project on the FASB agenda. The original objectives of the project were to require fair value measurement of investment property held by IPEs, and establish additional presentation and disclosure requirements for their financial reporting. Consideration of whether to develop guidance that would potentially require or permit investment property to be measured at fair value, regardless of what entity holds the investment, has been deferred.

What this means for real estate investment entities

Although this project is currently an inactive project on the FASB's agenda, real estate investment entities may be affected when the FASB revisits the IPE proposed guidance or application of investment company accounting for real estate entities at a later date.

Effective date

- The ASU is effective for interim and annual reporting periods in fiscal years that begin after December 15, 2013 (i.e., 2014 for calendar-year reporting entities).
- Early application is prohibited.

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