



ACCOUNTING • TAX • BUSINESS ADVISORY

2011-210

Comment Letter No. 49

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February 15, 2012

Ms. Susan M. Cospier
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

File Reference No. 2011-210

Re: Proposed Accounting Standards Update—*Real Estate—Investment Property Entities*
(*Topic 973*)

Dear Ms. Cospier:

Reznick Group, P.C. appreciates the opportunity to comment on the Proposed Accounting Standards Update—*Real Estate—Investment Property Entities (Topic 973)*, issued by the FASB.

We support the overall objective of the Board in improving the accounting for the real estate industry. However, we believe that the proposed guidance does not fully achieve this objective. Many of the criteria used to define an investment property entity are essentially the same criteria used to define an investment company, with the exceptions that an investment property entity may hold a single real estate investment and is not required to manage its investments on a fair value basis. Entities which would otherwise qualify to be investment companies should not be required to account for their investments differently just because those investments consist of real estate. The proposed criteria will result in some companies which do not manage their assets on a fair value basis and whose investors do not trade their investments based on the fair value of the entity's net assets being required to account for their real estate holdings at fair value. We believe that the desired accounting for real estate investments could be achieved under the guidance for investment companies with appropriate exceptions for single investments which are common in the real estate industry. We recommend that any considerations and concerns related to the application of lease accounting be addressed comprehensively for all lessors of real estate and not limited to real estate which meets the definition of an investment property.

Our responses to specific questions on which the Board is seeking comment are included in the attachment to this letter.

If you have any questions concerning our comments or would like to discuss any of our responses or recommendations in more detail, please feel free to contact Michael Beck at (404) 847-7728.

Yours truly,

Reznick Group, P.C.

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Question 1: Scope

The proposed amendments would require an entity that meets the criteria to be an investment property entity to measure its investment property or properties at fair value rather than require all entities to measure their investment properties at fair value. Should all entities measure their investment properties at fair value or should only an investment property entity measure its investment properties at fair value? Why? Is fair value measurement of investment properties operational? Please describe any operational concerns.

We agree that all investments in investment properties made by entities that are not investment property entities should not be required to be measured at fair value. However, as stated in our cover letter and elsewhere in our responses, we generally do not support creation of a new entity class for investment property entities. The proposed criteria to be an investment property entity is essentially the same as the criteria to be an investment company with the exceptions that an investment property entity may hold a single investment and an investment property entity is not required to meet the fair value management criteria. Creation of investment property entity category adds complexity and reporting nuances that are unnecessary. Entities that would otherwise meet the criteria to be an investment company should not be precluded from investment company status because they primarily hold real estate investments. In addition, criteria which are based on investment holdings can result in recurring changes in an entity's status over time as its investments change creating confusion for investors.

We do not agree with the requirement to measure an investment property at fair value during the construction/development phase. We encourage the Board to include a practicability exception for investment properties during construction. We believe fair value measurements during construction do not result in any meaningful or useful information to the users of the financial statements when compared to construction costs. Additionally, construction cost should reflect a reasonable approximation of fair value under the cost approach that is sufficiently accurate for financial reporting purposes during construction. Partially completed construction has little fair value outside the context of a presumption of eventual completion and use. Also, construction occurs over a relatively short time period. Scenarios where construction costs are over budget or where clear impairment indicators are present can be appropriately addressed in accordance with existing U.S. GAAP under Subtopic 360-10-35 during construction without requiring other construction/development situations to be measured at fair value prior to completion.

Question 2: Scope

The proposed amendments would require an investment property entity to measure its investment property or properties at fair value rather than provide an option to measure its investment property or properties at fair value or cost. Should fair value measurement of investment properties be required or permitted? Please explain.

We believe that investments in investment properties should not be required to be measured at fair value with the exception described in the next sentence. We believe that entities that qualify as investment companies and invest in real estate and manage their investments on a fair value basis should be required to report their real estate investments on a fair value basis.

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All investments in real estate are not managed on a fair value basis and should not be required to be measured at fair value. Real estate investments, perhaps more than any other type of investment, create scenarios where fair value measurements may not provide meaningful information to users of the financials. Requiring such entities to report their investments at fair value on a recurring basis may not provide meaningful information to users of the financials and likely could result in the entity incurring additional costs to perform the fair value measurements which could be significant.

Real estate, notwithstanding recent market corrections, is generally expected to appreciate in value based on changes in inflation. As a result of this general expectation, many entities that do not manage their real estate portfolio on a fair value basis and, therefore, would not qualify as investment companies nevertheless might be classified as investment property entities based solely on the expectation that their investment will provide them with total return consisting of capital appreciation and cash earnings. These types of entities may raise investor funds for the express purpose of investing in real estate to obtain operating cash flows. The value of an investment in these entities would be based primarily on those cash flows and less on the fair value of the investments. These entities manage their investments primarily on an operating cash flow basis. Such entities sell their investments when industry market cycles indicate optimal selling opportunities or when the attributes of a specific property no longer meet the investment criteria or objectives of the entity. Just as the Board recognizes that an exit strategy is not essential to an investment company that invests for income purposes and manages its investment on a fair value basis, we believe that real estate investments which are not managed on a fair value basis should not be forced to report at fair value just because they have an exit strategy.

On the other hand, situations may arise where fair value reporting is meaningful but might be precluded to the extent the entity does not qualify either as an investment property entity or an investment company. Providing an option to account for a specific investment property on a fair value basis can provide meaningful information to investors. We believe allowing some investments in real estate to be accounted for at fair value while others are accounted for at historical cost would not create confusion due to essentially similar assets being accounted for differently. Rather, allowing an option to account for a specific investment property at fair value would faithfully reflect the purpose of that investment and allow the entity to report the most meaningful information to its investors based on the purpose and intent of that investment.

Question 3: Scope

Do the criteria in the proposed amendments appropriately identify those entities that should be required to measure their investment property or properties at fair value, and, therefore, should be excluded from the scope of the lessor accounting model in the proposed Update on leases? If not, what changes or additional criteria would you suggest, and why are those criteria more appropriate?

We believe the criteria needs to be improved. Currently, the criterion focuses too much on an exit strategy and does not include fair value management criteria. This could result in entities that use investor equity to acquire real estate primarily for cash flow and operational purposes

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and which hold the real estate on a long-term basis to be classified as investment property entities even though they are not managed on a fair value basis.

Investors of real estate generally do not make investments in perpetuity. Eventually, they expect to exit every investment. The criteria of an exit strategy as opposed to fair value management places too much emphasis on eventual disposition of the real estate instead of on why the property should be measured at fair value. As a result, we believe the current criteria will result in entities being classified as investment property entities that do not manage their real estate holdings on a fair value basis and could exclude entities that do manage their real estate holdings on a fair value basis but do not have specific exit strategies. Based on the criteria set forth in the exposure draft, would an entity that invested in real estate and managed their investments on a fair value basis but that did not qualify as an investment property entity qualify as an investment company? If so, then we believe this will create more confusion than existed previously. We also believe requiring an exit strategy criterion makes it too easy to structure around the investment property criteria which could lead to abuse.

Question 4: Scope

The proposed amendments would require an entity to reassess whether it is an investment property entity if there is a change in the purpose and design of the entity. Is this proposed requirement appropriate and operational? If not, why?

While we agree with the concept, we disagree with how it is accomplished in the exposure draft because we believe the current guidance could lead to volatility in entity classification. Reassessment based on purpose and design is defined in the exposure draft as being based on whether the entity no longer continues to meet the criteria to be an investment property entity. We are concerned that this could lead to unintended reclassifications as entities fall in and out of meeting the criteria. If the concept of a change in purpose and design could be demonstrated by a change in investment holdings then we believe the unintended volatility in entity classification could occur, which would be confusing to users of the financial statements. We believe additional clarification and examples around a change in the purpose or design of the entity would be helpful.

Question 5: Scope

An entity that would be an investment property entity under the proposed amendments would be required to follow the accounting requirements in the proposed amendments even if that entity also would be an investment company under Topic 946. Is it appropriate for an entity that would meet the criteria to be both an investment property entity and an investment company under Topic 946 to be subject to the amendments in this proposed Update? If not, what alternative approach would you recommend if an entity would meet the criteria to be both an investment property entity and an investment company? Should the form of the entity (real estate fund versus real estate investment trust) dictate whether an entity should be an investment company or an investment property entity for accounting purposes? If yes, please describe the difference between the business activities of a real estate fund and a real estate investment trust to support your view.

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We disagree with requiring entities that would qualify as investment companies to follow the accounting requirements of investment property entities. An investment company that makes real estate investments should not be treated differently than an investment company that makes non-real estate investments. Based on the criteria, an entity that makes diversified investments that include real estate, but which are not limited to real estate, would be treated as an investment company while a similar entity making the same real estate investments without the diversification would be required to follow investment property entity accounting. Creating a separate classification of entities and accounting for entities that invest in real estate solely is unnecessary and creates situations where similar entities are treated differently.

In addition, because the criteria for investment property entities are similar to that of investment companies, many real estate investments will be excluded from being an investment company. Instead of creating a new investment property entity classification, we believe it makes more sense to amend the investment company criteria to incorporate real estate investments.

Question 6: Nature of the Business Activities

To be an investment property entity, the proposed amendments would require substantially all of an entity's business activities to be investing in a real estate property or properties. Should an entity's business activities be limited to investing in a real estate property or properties rather than investing in real estate assets in general (such as real-estate-related debt securities and mortgage receivables) to be an investment property entity? If not, why? Is this requirement operational? Please describe any operational concerns.

We do not support this requirement because it creates operational issues in situations where an entity's investment holdings change over time potentially causing it to fluctuate between classification as an investment property entity and an investment company or some other type of entity. For those entities that would otherwise meet the criteria to be an investment company, we see no reason why such entities should be subject to classification as an investment property entity. Further, for those entities that would not be classified as an investment company, we see no reason why such entities should be treated as investment property entities. It creates a tenuous situation where entities are neither investment companies nor other entities.

Question 7: Nature of the Business Activities

The implementation guidance in this proposed Update specifies that when evaluating whether substantially all of the parent entity's business activities are investing in a real estate property or properties, the parent entity would not consider real estate properties held indirectly through investments in which the parent entity does not have a controlling financial interest. Should the evaluation of an entity's business activities consider properties held through noncontrolling financial interests (for example, investments in which the entity can exercise significant influence)? Why or why not?

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We believe indirect and non-controlling investments in real estate entities should be considered when evaluating whether substantially all of the parent entity's business activities consist of investments in real estate property or properties. Requiring entities to hold a controlling financial interest potentially eliminates entities which hold significant investments in real estate from being considered investment property entities. Further, when an entity holds a controlling financial interest in a property, it makes it more difficult to determine whether the investment was made for investment or operating purposes.

Question 8: Express Business Purpose

To be an investment property entity, the proposed amendments would require that the express business purpose of an entity is to invest in a real estate property or properties for total return with an objective to realize capital appreciation, for example, through disposal of its real estate property or properties. Real estate properties held by an entity for either of the following purposes would not meet this criterion:

- a. The entity's own use in the production or supply of goods or services or for administrative purposes
- b. Development for sale in the ordinary course of business upon completion (such as land developers and home builders)

Should an entity whose express business purpose is to hold real estate properties for the reasons listed above be excluded from the amendments in this proposed Update? If not, why? Is the express-business-purpose criterion operational? Please describe any operational concerns.

We generally agree with the exclusion of such properties. However, development is a common activity performed in connection with many real estate investments. Some real estate is developed to be sold upon completion, while other real estate is developed to be operated and sold later at an undetermined future date as an income producing property. We believe that more clarification is needed regarding whether the exclusion would apply to all developed properties or just those intended to be sold upon completion. Such clarification should address the difference between properties intended to be sold immediately upon completion and those intended to be sold at an indeterminate future date following completion.

Question 9: Express Business Purpose

To meet the express-business-purpose criterion, the implementation guidance in this proposed Update would require that an investment property entity have an exit strategy to dispose of its real estate property or properties to realize capital appreciation to maximize total return. An entity that invests in a real estate property or properties to collect rental income long term and does not have an exit strategy for its real estate property or properties would not be an investment property entity under the proposed amendments. Should those entities be excluded from the amendments in this proposed Update? If not, why? Is the exit strategy requirement operational? Please describe any operational concerns.

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We generally agree that an investment property should be acquired for investment purposes as opposed to operational purposes or as inventory held for sale. However, the requirement of an exit strategy as the primary indication that the property is acquired for investment purposes while keeping the criteria to maximize total return appears to be somewhat arbitrary and exclusive. We believe it is possible for properties to be held for investment purposes without an exit strategy on the part of the entity as a whole. Having an exit strategy may be an indication of investment intent. However, total return on almost all real estate investments requires disposal of the property at some future date in order to access residual values and receive a return of the original investment. Income received from income producing properties often provides a significant source of income to investors. However, it would be rare that such income would be enough to provide investors with both a return on their investment as well as a return of their investment. Consequently, with or without an express exit strategy, investors of all types would expect eventual disposal of the property sometime during the term of their investment. This would be true of any investment, not just real estate. We do not understand why an exit strategy is critical to real estate investments when it is not a criterion for other types of investments held by investment companies. It appears that real estate is being treated in a unique manner that may result in some real estate being considered investment property when it is held primarily as an operating investment with excellent residual return prospects. We believe a better distinction could be made based on the purpose of the investment and of the investors with less emphasis placed on exit strategy.

Question 10: Unit Ownership and Pooling of Funds

To be an investment property entity, the proposed amendments would require an entity to have investors that are not related to the entity's parent (if there is a parent) and those investors, in aggregate, must hold a significant ownership interest in the entity. Is this criterion appropriate? If not, why?

We agree with the criteria of the proposed amendment, however, we believe additional clarification should be added. As currently written, the proposed guidance leaves out investors who have a significant investment in a specific property that do not have a significant interest in the property ownership entity.

Question 11: Unit Ownership and Pooling of Funds

To be an investment property entity, the proposed amendments would provide an exemption from the unit-ownership and pooling-of-funds criteria for a subsidiary entity that (a) has a parent entity that is required to account for its investments at fair value with all changes in fair value recognized in net income in accordance with U.S. GAAP or (b) has a parent entity that is a not-for-profit entity under Topic 958 that measures its investments at fair value. Should this exemption be available only to a subsidiary entity with a parent entity that is (a) required to account for its investments at fair value in accordance with U.S. GAAP or (b) a not-for-profit entity under Topic 958 that measures its investments at fair value? If not, which entities should be permitted to apply the exemption and why?

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We generally agree with this requirement. However, we believe it is important to allow for diverse forms of ownership. It is possible for an entity to be managed by a party which has no equity at risk and where all of the equity at risk is contributed by a single owner who is independent of the manager. Such a situation should not preclude treatment of the entity either as an investment company or as an investment property entity.

Question 12: Measurement

The proposed amendments would require real estate properties other than investment properties that are held by an investment property entity to be measured in accordance with other U.S. GAAP. Should an investment property entity be required to measure those properties at fair value with all changes in fair value recognized in net income instead of applying other U.S. GAAP? Why or why not?

Generally we agree that investments in real estate properties other than investment properties that are held by an investment property entity should be allowed to be measured in accordance with other U.S. GAAP and should not be required to be measured at fair value. Further, we believe investment properties that are in construction should not be treated as investment properties prior to the date they are completed and placed into service.

We believe investments in real estate that are for use in operations of the entity are not part of any investment plan and that fair value information is not essential to management of those properties. We believe that property being developed for sale upon completion should be measured at historical cost and any profit deferred until sold.

Question 13: Measurement

The proposed amendments would require a right-of-use asset in which the underlying asset meets the definition of an investment property to be measured at fair value with all changes in fair value recognized in net income. Should those right-of-use assets be measured at fair value with all changes in fair value recognized in net income? If not, why and which measurement attribute would you recommend for those right-of-use assets?

We do not agree with measuring right-of-use assets at fair value just because the underlying property would be considered an investment property. The essential business purpose of entering into leases is to obtain the use of the underlying property. While a favorable rental rate may improve operating profitability, we believe that entering into leases is not an investment activity unless the entity can sub-lease the property at a higher rate. We believe adding right-of-use assets to the list of what qualifies as an investment property will be confusing and could lead to leases that are not entered into for investment purposes being required to be measured at fair value.

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Question 14: Interests in Other Entities

The proposed amendments would require an investment property entity to evaluate whether an interest in (a) another investment property entity, (b) an investment company as defined in Topic 946, or (c) an operating entity that provides services to the investment property entity should be consolidated under Topic 810. Should an investment property entity consolidate controlling financial interests in those entities? If not, why? Should an investment property entity consolidate controlling financial interests in other entities? If yes, why?

We agree that an investment property entity should evaluate whether it should consolidate an interest in another investment property entity or an investment company in accordance with Topic 810. However, we believe that that an investment company or an investment property entity should make investments in other entities for investment purposes and not for the purpose of controlling the operations of those entities.

Consolidation of investments in other investment property entities or investment companies creates a reporting perception that the assets are direct investments of the reporting entity when in fact they are indirect investments. We believe all investments of investment companies and investment property entities should be presented on a fair value basis in order to reflect the purpose and nature of their investments. The criterion that addresses the types of investment(s) that an investment property entity or investment company can make should effectively preclude investments in other entities for the purpose of controlling the operations of those entities.

Question 15: Interests in Other Entities

The proposed amendments would prohibit an investment property entity from applying the equity method of accounting in Topic 323 unless the investee is an operating entity that provides services to the investment property entity. Is that exception to the equity method of accounting requirements in Topic 323 appropriate for investment property entities? If not, why?

We agree with the proposed amendment's exception to the equity method of accounting.

Question 16: Interests in Other Entities

The proposed amendments would require an investment property entity to measure investments in which it does not have a controlling financial interest or cannot exercise significant influence in accordance with U.S. GAAP. For example, that would currently require held-to-maturity debt securities to be measured at amortized cost and would permit certain equity securities to be measured using the cost method, unless the fair value option in Topic 825, Financial Instruments, is elected. Should an investment property entity be required to measure those investments at fair value with all changes in fair value recognized in net income instead of applying other U.S. GAAP? Why or why not?

As discussed in our response to Question 5 above, instead of creating a new investment property entity classification, we believe it makes more sense to amend the investment company criteria to incorporate real estate investments. The current scoping of the proposed amendments for

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investment property entities is at the entity level, however certain investments of the investment property entity would be measured at cost. We believe this is inconsistent with the proposed scoping of the guidance at the entity level for investment properties which implies that substantially all of its investments should be carried at fair value through earnings. As such, we propose the investment company guidance be amended instead of creating a separate classification of entities and accounting for entities that invest in real estate solely. Having a separate classification for real estate property entities is unnecessary and creates situations where similar entities are treated differently.

Question 17: Financial Liabilities

The proposed amendments would require an investment property entity to measure its financial liabilities (such as its own debt) in accordance with other U.S. GAAP, which currently requires amortized cost measurement unless the fair value option in Topic 825 is elected. Should an investment property entity be required to measure its financial liabilities at fair value with all changes in fair value (including changes in an entity's own credit) recognized in net income instead of applying other U.S. GAAP? Why or why not?

We believe liabilities should be measured at fair value in situations where the entity is reporting its assets and liabilities at fair value. Measuring specific assets or liabilities at fair value does not accurately reflect the fair value of the entity as a whole. Given the investment purpose of an investment property entity, we believe all of its investments and its related liabilities should be measured at fair value as long as such measurements appropriately reflect any restrictions which might affect the borrower's ability to trade or otherwise liquidate the liability.

Changes in fair value related to interest rate changes may not be available to the borrower in some situations. The fact that a market participant would pay less to assume a liability because of interest rate changes is only available to the borrower if the liability can be assumed, which may not be permitted under the terms of the loan. Other loans may have prepayment penalties or other yield maintenance provisions which effectively prevent borrowers from taking advantage of favorable market rates.

Question 18: Rental Revenue Recognition

The proposed amendments would require an investment property entity to recognize rental income on investment properties subject to a lease when lease payments are received or as the lease payments become receivable in accordance with the contractual terms of the related lease rather than on a straight-line or other basis. Is that basis of recognizing rental revenue appropriate for investment properties measured at fair value? If not, why?

We agree with the proposed guidance for rental income in situations where a property is measured at fair value.

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Question 19: Practical Expedient for Measurement of an Interest in an Investment Property Entity

The proposed amendments would permit, as a practical expedient, an entity to estimate the fair value of its investment in an investment property entity using the net asset value per share (or its equivalent) of the investment if the entity would transact at the net asset value per share. Are there investments that currently qualify for the practical expedient that would no longer qualify for the practical expedient because of the proposed amendments? If so, please identify those types of investments.

No response

Question 20: Disclosure

Are the proposed disclosures appropriate for an investment property entity? If not, which disclosures do you disagree with? Should any additional disclosures be required? If so, why?

We agree with the proposed disclosure guidance.

Question 21: Effective Date and Transition

Should an entity recognize the effect of adopting the requirements in this proposed Update as an adjustment to the beginning balance of retained earnings in the period of adoption? If not, what transition requirements would you recommend and why?

We agree with the proposed guidance.

Question 22: Effective Date and Transition

How much time would be necessary to implement the proposed amendments?

No response.

Question 23: Effective Date and Transition

The proposed amendments would prohibit early adoption. Should early adoption be permitted? If yes, why?

We agree with the proposed guidance that early adoption should be prohibited.

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Question 24: Nonpublic Entities

The proposed amendments would apply to both public and nonpublic entities. Should the proposed amendments apply to nonpublic entities (such as private companies and not-for-profit organizations)? If not, how should the proposed requirements differ for nonpublic entities and why?

Relief for small, single-purpose entities that hold a single property should be provided. Such entities should not be required to measure their property on a fair value basis since the cost of such measurements could be significant in relation to the net operating income of the property. Such entities will likely be liquidated upon disposition of the property and investors will likely not be able to trade their investment in the entity unless they are willing to do so at a significant discount. Requiring fair value measurements on a recurring basis for small properties would be a hardship and would provide little value to the investor in relation to the cost. In situations where the investors believe they would benefit from fair value reporting they could request it; however, it should not be required under GAAP.

In addition, lack of a practicality exception for properties in construction will likely be perceived negatively by smaller entities as an unnecessary fair value measurement that provides information that is irrelevant and costly when compared to construction cost information.