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Technical Director  
Financial Accounting Standards Board  
File Reference No. 2011-200, 2011-210  
401 Merritt 7  
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**RE: Proposed Accounting Standards Update-*Financial Services-Investment Companies*  
Proposed Accounting Standards Update - *Real Estate-Investment Property Entities***

To Whom It May Concern:

The Appraisal Institute (AI) appreciates the opportunity to provide comments on the proposed Financial Accounting Standards Board (FASB) Accounting Standards Updates regarding investment companies and investment property entities referenced above.

AI is a global membership association of real estate valuation professionals with nearly 23,000 members in nearly 60 countries throughout the world. Our mission is to advance professionalism and ethics, global standards, methodologies, and practices through the professional development of property economics worldwide. The majority of AI members are practicing real estate valuation professionals and property analysts who provide valuation-related services to such clients as mortgage lenders, financial institutions, government agencies, attorneys, accountants and financial planners as well as homeowners and other individual consumers.

AI designated members have met rigorous requirements relating to education, testing, experience and demonstration of knowledge, understanding and ability. Those members holding the Appraisal Institute's MAI and SRPA designations are experienced in commercial valuation, including industrial, retail and multifamily properties. In addition, some AI members are trained in the valuation of intangible items in real estate, an important factor in certain property types, such as hotels. Those holding the SRA designation are experienced in residential valuation. All Appraisal Institute members adhere to a strictly enforced Code of Professional Ethics and Standards of Professional Appraisal Practice.

### **General Comments**

We continue to support the requirements contained in Accounting Standards Codification (ASC) Topic 946 that require entities that meet the definition of an investment company to report all of their investments, specifically their equity investments in real estate, at fair value as outlined in Topic 820: *Fair Value Measurements and Disclosures*. In addition, we strongly support the adoption of the Accounting Standards Update (ASU) for investment property entities (Topic 973) that would streamline U.S. accounting requirements for investment properties with those contained in the International Accounting

Standards (IAS 40), and would require, rather than allow, as IAS 40 does, entities that meet the definition of an investment property entity to report the value of their real estate holdings at fair value.

Further, not only do we support the application of fair value requirements for the reporting of the real estate holdings of investment companies and investment property entities, but we believe that the FASB and the IASB should adopt more universal requirements for the use of fair value measurements for the reporting of the value of an entity's real estate assets (i.e., for non-investment companies and non-investment property entities).

Real estate valuation professionals stand ready to assist the users, preparers and auditors of financial statements as they transition from the use of existing accounting standards to the use of fair value for real estate assets. As it relates to the users of financial statements, real estate appraisers can help to understand how real estate values are credibly and reliably developed. Real estate valuation professionals can also assist the preparers of financial statements in developing real estate valuation tools and products that meet their needs in a timely and cost effective manner. Lastly, real estate valuation professionals can assist auditors of financial statements by providing them with information and services that allow the auditors to determine the validity of a value.

### **Appraisers Are Already Providing Timely and Cost Effective Fair Value Appraisals**

We understand that some preparers of financial statements continue to have concerns with the reliability of financial reports that utilize fair value measurements, particularly for the reporting of the value of equity investments in real estate. Specifically, concerns have been expressed about insertion of "subjective" valuation opinions in the financial reporting process. In addition, we understand that there are some concerns amongst the preparers of financial statements about the costs associated with requirements for investment companies and investment property entities to determine the fair value of real estate assets at each measurement period. Fortunately, these are two issues that our organization has worked hard to address for the last several years.

#### *Timing and Scope of Work*

Real estate valuation professionals with the proper training and experience are trained to objectively and independently develop credible and reliable opinions of value, even when the development of that opinion of value requires numerous and extensive assumptions about future events. While real estate appraisals are opinions, these opinions are supported by market information, data, research and analysis. In fact, we train our members to prepare to defend these opinions in court and during audits. To the extent there are concerns regarding subjectivity of these opinions, we suggest users, preparers and auditors seek out qualified valuation professionals who have demonstrated competency to prepare such valuation assignments.

In addition, U.S. appraisal standards (*Uniform Standards of Professional Appraisal Practice*, "USPAP") offer the flexibility for qualified third party appraisers to provide limited scope and updated appraisal assignments ("updates") at cost effective pricing. In fact, appraisal updates are the norm throughout the real estate valuation industry. Real estate investment funds, pension funds, insurance companies and

others have already adopted models for the presentation of investment performance data that are substantially similar to what is proposed by FASB for financial reporting purposes under the two exposure drafts. These standards rely on third party valuations performed on a recurring basis to support financial statements. These types of assignments are also the norm under investment reporting standards such as the Global Investment Performance Standards (“GIPS”)<sup>1</sup> and the Real Estate Information Standards (“REIS”)<sup>2</sup>, which may already apply to certain entities covered under the proposed investment company standard. All of these initiatives are gravitating toward the preparation of periodic collateral valuations that are prepared by third party professionals. For instance, GIPS and REIS, which apply to equity investments in real estate on behalf of pension plan sponsors, call for annual external valuations by qualified real estate appraisers. We believe such practices help address concerns over transparency, independence and changing market conditions. In this regard, we see FASB’s proposals as a logical extension or outgrowth of industry led developments in the United States and throughout the world.

Because valuation professionals are only reviewing the validity of existing information, and updating it for changes in the marketplace since the last measurement period, the aforementioned “appraisal updates” can be provided to the preparers of financial reports in a prompt manner that meets their needs for timely and reliable information. Here, the contract between the client and the valuation professional simply dictates the reporting period, whether it is on a monthly, quarterly, or annual basis.

Further, we believe there are several ways in which costs can be addressed through appropriate scope of work decisions, including, but not limited to the following:

1. An investment company or an investment property entity can engage a real estate valuation firm to prepare a “full” appraisal at the time a real estate asset is added to the entity’s financial statements. The entity may obtain a quarterly re-examination of the value of the asset and another full real estate valuation annually. We have seen valuations prepared in the second and third years of such agreements performed for substantially below the original fee. As stated above, such arrangements are already performed for equity investments in real estate.
2. USPAP also allows an individual appraiser to prepare the subsequent re-examinations even when they did not perform the original valuation. This would allow an investment company or an investment property entity to engage a due diligence firm to prepare subsequent valuations for its entire portfolio, thereby reducing valuation costs significantly.

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<sup>1</sup> The Global Investment Performance Standards published by the CFA Institute are available at <http://www.cfapubs.org/doi/pdf/10.2469//ccb.v2010.n5.1>

<sup>2</sup> The Real Estate Information Standards published by the Pension Real Estate Association in cooperation with the National Council of Real Estate Investment Fiduciaries and the National Association of Real Estate Investment Managers, is available here <http://www.prea.org/research/reis.cfm>

### Cost and Use of Third Party Specialists

We have seen some comments to FASB express concern about the costs associated with utilizing fair value measurements, citing estimates for annual increased expenses relating to retaining third party valuation service providers. In our view, some of these comments vastly overstate the difficulty and expense of determining fair value for real estate that utilizes valuation specialists. In talking with our members about some of the estimates that have been provided to FASB, we believe actual expenses would only be a fraction of the cost contentions being made with appropriate scope of work specified in engagement letters. The notion that use of external valuation professionals is somehow new in the United States is false, as many companies that invest in real estate are already reporting at fair value. The subject of government attention now is whether such entities should be compared on an apples-to-apples basis, a point which we support and are eager to assist.

Further, there are many investment property entities outside of the U.S. that have elected to prepare their financial statements in accordance with IAS 40. According to a large Canadian real estate consulting, brokerage, and valuation firm, "Prior experience with countries that have adopted the IFRS suggests that most (86%) organizations opt for the Fair Value Model." While the FASB proposal will mandate the use of fair value, the fact that such a strong majority of firms that have fair value as an option have adopted it speaks volumes to the benefits that use of fair value brings to the users of financial statements.

In addition, many of these entities utilize independent, third-party real estate valuers to assist in the establishment of fair value at each measurement period. According to the previously mentioned real estate firm, "Prior experience with countries that have adopted the IFRS suggests that 98% of entities use External Valuers to support their Fair Value. 86% of properties are valued annually (or more frequently) using external valuations. 76% of entities disclose the name of their External Valuer in their financial statements: 22% include the External Valuer's report in their annual statement."<sup>3</sup>

Real estate valuers abroad have adapted to the needs of preparers of financial statements and have developed valuation products that are both economical and timely. This is true of large segments of the real estate valuation profession in the United States, and we have no reason to believe full integration is not achievable as fair value becomes more widely accepted under GAAP.

### **Fair Value vs. Historical Cost**

While the benefits and drawbacks of both fair value and historical cost have been debated extensively, we believe the recognition of real estate assets at their market (or fair) value on an entity's financial statements provides more relevant and transparent information to investors than historical cost figures. Fair value is grounded in economic reality, rather than mathematical certainty, and facilitates informed investment decision making. In fact, utilization of historical cost and depreciation, rather than fair value, for real estate investments may understate or overstate the value of those properties significantly. An understatement of the value of real estate holdings can result in higher reported leverage. This could

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<sup>3</sup> "The f Word." Turner, Drake, and Partners, Ltd. Newsletter Winter 2009-2010 available at <http://www.turnerdrake.com/newsresearch/newsletters.asp>

result in an investment property entity violating debt incurrence covenants sooner than they would if the fair value of the real estate were considered. Understatement also limits the ability of an investment property entity to incur additional debt. While it is unlikely that many investment property entities will capitalize on lower reported leverage when fair value measurements are utilized, the ability to incur additional debt could permit the investment property entity to invest in new real estate holdings and could have trickle down effects for the overall U.S. economy.

Overstatement has similar negative impacts. If the value of real estate is over-stated, lenders will be lead to believe that there is additional borrowing capacity that could result in over-leverage. These impacts are being seen daily in the bankruptcy courts and foreclosure actions occurring across the country.

For example, with regard to large holders of timber properties, historical cost can even be a misleading measure of asset value especially when companies have held lands for 20 years or more and have depleted per acre values in the \$20-50/acre range. The cost-basis booking of timberland values was one of the main drivers behind the break-up of the integrated forest products companies over the last 20 years. The company financial statements vastly under-reported the timberland holdings value and as a result the companies were undervalued and thus take-over targets. For a timberland REIT in particular, whose worth is essentially all tied up in its timberlands, there should be no question that investors should have access to best estimates of its fair (or market) value.

### **Scope of Definition of Investment Companies and Investment Property Entities**

While we see the modification of existing Topic 946 and the adoption of Topic 973 as steps in the right direction towards universal requirements for the adoption of fair value for equity investments in real estate we are, however, disappointed with the revised definition of an investment company, and with the limited applicability of the proposed investment property entity standards.

Under the proposed standards, some entities that were previously within the scope of Topic 946 will not satisfy the definition of either an investment company or an investment property entity as is contained in these two revised standards. These entities, will no longer be required to report the value of their investments in real estate assets utilizing fair value measurements, and will instead be required to report the value of real estate assets utilizing other relevant accounting standards. We do not support the scoping out of any entity that is currently utilizing fair value for the reporting of real estate assets from these two standards, and we urge FASB to reconsider or clarify this section.

In addition, we are concerned that both of the proposed accounting standards updates, and in particular the proposed investment property entity standard, include only passing references to disclosure requirements and for the use of qualified valuation professionals. IAS 40 requires preparers to disclose the extent to which the fair value of investment property is based on a valuation by a qualified independent valuation professional and when a third party valuation professional has not been used<sup>4</sup>. For consistency, we believe FASB should incorporate similar provisions in the final accounting standards updates.

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<sup>4</sup> From <http://www.iasplus.com/standard/ias40.htm>

Appraisal Institute Comments on Proposed ASU  
February 15, 2012  
Page - 6 -

### **Summary**

In summary, we support the proposed accounting standards updates that would require that investment companies and investment property entities utilize fair value measurements for the reporting of their equity investments in real estate. Obtaining periodic valuations of real estate assets is being done by professional real estate valuers today, is not overly costly, and will significantly improve the transparency and comparability of financial statements. However, we believe the requirements for the utilization of fair value measurements for equity investments in real estate should be expanded to other types of entities that are not scoped into the definition of either an investment company or an investment property entity. Our answers to the specific questions posed by FASB in each of the proposed standards are attached to this document as Appendix A.

We appreciate the opportunity to comment on these two proposed accounting standards updates. Our answers to the specific questions posed by FASB in each of the Exposure Drafts are attached to this document as an Appendix. If you should have any questions, please contact Bill Garber, Appraisal Institute Director of Government and External Relations at (202) 298-5586 or [bgarber@appraisalinstitute.org](mailto:bgarber@appraisalinstitute.org), or Scott DiBiasio, Manager of State and Industry Affairs at (202) 298-5593 or [sdibiasio@appraisalinstitute.org](mailto:sdibiasio@appraisalinstitute.org).

Sincerely,

Appraisal Institute

## Appendix

### **Selected Questions - Comments Specific to Proposed Accounting Standards Update-*Financial Services-Investment Companies (Topic 946)***

#### **Question 3**

We strongly support the removal of the scope exception in Topic 946 for real estate investment trusts (REIT), which would bring REITs within the scope of this standard and thus require the use of fair value measurements for their assets. Under the limited definition of "investment property entity" contained in proposed Topic 973, there are some real estate funds and REITs that would not qualify as investment property entities (i.e., those who do not meet the criteria that "substantially all of the entity's business activities are investing in a real estate property or properties"). These include Hybrid REITs that both own real estate assets, as well as loan money to real estate owners and invest in existing mortgages or mortgage backed securities. In addition, REITs that also manage the properties that they own may not satisfy the definition of an investment property entity. However, while these entities may not meet the "substantially all" criteria, they may, nonetheless, still have large equity investments in real estate assets that should be reported at fair value. Removal of the scope exception in Topic 946 would require that these REITs utilize fair value measurements for their assets, and would help to ensure comparability among the real estate holdings of all public and non-public REITs.

#### **Question 5**

We believe that all entities having as one of their express business functions to own and invest in real estate assets should be required to account for real property assets at fair value, either under the investment company standard or via the investment property standard. An entity that owns and invests in real estate should not be excluded from both the investment company and investment property entity standards merely because they conduct business in other areas, some of which may support and contribute to their ownership and management of real estate assets.

#### **Question 11**

We support the provision that would require that substantially all of an investment company's investments, including their equity investments in real estate assets, be managed and evaluated utilizing fair value measurements. This will help to ensure consistency among different entities as there will be no opportunity for one entity to exclude a certain asset or a certain class of assets from fair value accounting, while another entity uses fair value accounting for the same type of assets. In addition, disclosure requirements relating to use of third party valuation professionals or lack thereof, should be consistent with those currently found in IAS 40.

## **Question 22**

Yes, the proposed amendments should apply to both public and non-public entities. The level of comparability amongst two investment companies should be the same, regardless of whether an investment company is a public entity or a non-public entity. As an example, two investment companies, one a public entity and one a non-public entity may jointly own an office building on a 50%-50% basis. There is no reason why one of these entities should be required to account for real property assets at fair value, while the other is allowed to report depreciated cost of similar assets.

## **Comments Specific to Proposed Accounting Standards Update-Real Estate – Investment Property Entities (Topic 973)**

### **Question 1**

We believe that all entities should account for their investment properties at fair value. Use of fair value measurements would provide more relevant and transparent information to investors than does depreciated cost. There are many entities with extensive real estate portfolios that are held for income and capital appreciation. However, these entities would not satisfy the definition of an investment property entity because they do not meet the “substantially all” standard. As currently included in the ASU, the definition of an investment property entity is severely limited and may have the effect of only including certain real estate investment trusts and certain real estate funds. Other REITs and real estate funds would continue to use other U.S. accounting standards. This would reduce comparability among entities that have large real estate investments regardless of whether or not investing in real estate is their sole business purpose.

### **Question 2**

Fair value measurement of investment properties should be required, rather than merely permitted. This will help to ensure comparability on the part of investors among similar entities with similar business purposes.

### **Question 6**

We believe that the scope of the ASU should be broader and should also require that entities that invest in other types of real estate related assets (i.e., mortgage backed securities, mortgage receivables, etc.), not just real estate properties, also be required to report the value of their real estate assets at fair value.

### **Question 8**

We do not feel that entities owning real estate assets that they are developing for subsequent sale should be excluded from the requirements to report at fair value. For instance, there are many REITs that not only own properties for income and capital appreciation, but also own properties that they are developing or intending to develop. These properties may continue to be held by the entity, or may be sold upon

completion. We do not believe that any entity that has real estate assets should be excluded from the requirements for fair value measurements.

**Question 9**

We do not believe that an entity with real estate assets that is being held for income and capital appreciation, but that does not have an exit strategy (i.e., a time or performance based target), should be excluded from the requirements to report at fair value. Simply put, an entity may not necessarily have an exit strategy for a property or a group of properties. Having, or not having, an exit strategy should not be a criterion upon which an entity is scoped into or scoped out of the requirements for the use of fair value measurements.

**Question 10**

An entity's ownership structure should not be the factor that determines whether or not an entity is required to use fair value accounting for the entity's real estate assets. While the rules for the ownership structure of REITs is fairly restrictive, we do not believe an entity's ownership structure is consequential to whether or not that entity should be required to report its real estate related assets at fair value.

**Question 11**

Again, many aspects of the proposed standard are designed to "scope out" as many entities from the fair value requirements as possible. The focus of the standard should be producing consistent and highly reliable financial statements, not limiting its applicability to the point that investors do not benefit from its effects. The proposed definition of an "investment property entity" is already limited enough. The standard should not further limit the application of fair value.

**Question 12**

Yes, an investment property entity that holds real estate properties other than investment properties should also be required to report fair value for the non-investment real estate properties. It does not seem to make any sense at all to report different values determined under different standards different real estate assets held by the same entity.

**Question 18**

We agree with the proposal for IPEs to recognize rental income 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. Doing so would be generally consistent with appraisal theory whereby an appraiser utilizing a discounted cash flow model to determine the fair value of an investment property bases the future cash flow stream on the lease payments that are contractually due, rather than on a straight line basis.

**Question 19**

We support the ability of an investor to estimate the fair value of its investment in an investment property entity using the net asset value (NAV) per share. This is due to the fact that an investment property entity would be required to report the fair value of its real estate assets in calculating the NAV. However, we would request a reiteration in the investment property entity standard that an investor in an investment property entity that does not calculate a NAV would be required to utilize the fair value measurement requirements contained in Topic 946 in order to calculate the value of the entity's interest in the real estate holdings of the investment property entity.

**Question 20**

First and foremost, we do not agree that the challenge in estimating the fair value of real estate is formidable, so long as the preparers of financial statements utilize qualified, independent third-party valuation professionals. With that said, the users of financial statements are entitled to know the primary determinants used in the development of a fair value for an entity's real estate holdings. In addition, requirements for clear disclosures regarding the methodologies utilized in determining fair value, and criteria for the selection of independent third-party accredited professionals would assist users of financial statements in understanding how an entity has derived its fair values.