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Relief Ahead for Lessors?

A recent proposal by the FASB could enable lessors of real estate to avoid the burdens of previously proposed changes to the lease-accounting provisions of U.S. GAAP.

Over the past year, the Financial Accounting Standards Board (FASB) has made several tentative standard-setting decisions that would profoundly change the leasing provisions of U.S. Generally Accepted Accounting Principles (GAAP). For both lessors and lessees, the changes would significantly increase the cost and complexity of lease accounting. But the FASB has also recently proposed additional changes that could provide significant relief for lessors of real estate. In this month's column, I'll summarize the key provisions of the FASB's recent proposal and their implications.

Real Estate Investments

Real estate investment trusts (REITs), real estate investment funds (REIFs), and other kinds of entities routinely hold real estate assets for investment purposes. Under current U.S. GAAP, a reporting entity measures its real estate investments at either fair value or depreciated cost, depending on the circumstances.

In March 2010, the FASB undertook a project to improve accounting for real estate investments under U.S. GAAP. The project was also intended to minimize future differences between U.S. GAAP and International Financial Reporting Standards (IFRS), especially with regard to entities to be excluded from the scope of a new lessor-accounting model that the FASB and the International Accounting Standards Board (IASB) would later propose.

On October 21, 2011, the FASB issued an Exposure Draft (ED) of a proposed Accounting Standards Update (ASU) that would add Topic 973, *Real Estate—Investment Property Entities,* to the Board's *Accounting Standards Codification®* (ASC) and make conforming amendments to other topics. Specifically, the FASB's proposal would change U.S. GAAP by:

- Defining a new kind of reporting entity—an *investment property entity,*
- Defining a new kind of asset—*investment property,*
- Providing new guidance on accounting for investment properties by investment property entities, and
- Introducing additional presentation and disclosure requirements for investment property entities.

Investment Property Entities

Under the FASB's proposed ASU, an entity would be an investment property entity if it meets all of the following criteria:

- Substantially all of the entity's business activities involve investing in real estate.
- The express business purpose of the entity is to maximize total return, including capital appreciation, from investments in real estate.
- The entity's net assets are attributed to units of ownership such as equity or partnership shares.
- The funds of the entity's investors are pooled rather than being segregated by investor.
- The entity provides investors with financial results about its investing activities.

For each criterion, the proposed ASU provides a detailed definition and implementation guidance that reporting entities would be required to follow. An entity initially would determine whether it's an investment property entity at the time it is formed. The entity would reassess that determination whenever there's a change in its purpose and design. Certain subsidiary entities, such as those

whose parent entity is required to account for its investments at fair value under other provisions of U.S. GAAP, would be exempt from having to meet the "units of ownership" and "pooling of funds" criteria in order to be considered investment property entities.

Investment Property

The proposed ASU defines investment property as real estate property, including any property improvements or integral equipment, held by an investment property entity for investment purposes. This definition excludes property held for other purposes, such as the entity's own use in the production or supply of goods or services. A right-of-use asset held by a lessee in accordance with pending amendments to the lease-accounting provisions of U.S. GAAP would be treated as investment property if the underlying asset meets the definition of investment property.

Under the proposed ASU, most investment properties initially would be measured at cost, but right-of-use assets that are investment properties initially would be measured at fair value. Subsequently, all investment properties would be measured at fair value, and changes in fair value would be recognized in net income.

Most significantly, investment property leased to another party would be excluded from the scope of the complex lessor accounting model that the FASB and the IASB proposed via coordinated EDs in August 2010. The investment property entity simply would recognize rental revenue from investment property as payments become due.

Key Implications

The changes to U.S. GAAP documented in the proposed ASU would have several key implications for lessors of real estate. Because the highly specific criteria that define an investment property entity would preclude most entities from treating real estate leased to other parties as investment property, lessors should consider spinning off their leased real estate into a separate entity if it would help the new entity qualify as an investment property entity.

Furthermore, because real estate *must* be treated as investment property if the relevant criteria are met, investment property entities would be required to periodically remeasure their investment property's fair value, which could be a complex and costly ongoing exercise.

Additionally, from the investor's perspective, the highly specific criteria that define an investment property entity would cause minor differences in the legal form or ownership of real estate leased to other parties to result in major differences in the lessor's reporting of the character, amount, and timing of revenue from the lease.

A Look Ahead

After considering the feedback it receives on the ED, the FASB will determine the effective date for the proposed changes, which would be effective for interim and annual reporting periods in fiscal years that begin on or after the effective date. Early adoption would be prohibited.

As with all of the FASB's Exposure Drafts, the proposed ASU on investment property entities is freely available in electronic format at the Board's website (www.fasb.org). The ED comment period originally was scheduled to end January 5, 2012, but the FASB recently extended the comment period to February 15, 2012. At this time, lessors of real estate should review the ED and consider providing feedback—positive or negative—to the FASB. **SF**

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