

## Heads Up

### In This Issue:

- Overall Guidance and Scope
- Measurement of Investment Properties
- Other Investments
- Rental Revenue Recognition
- Presentation and Disclosure
- Effective Date and Transition
- Appendix — Differences Between the Proposed ASU and IAS 40

Fundamental differences in the accounting for investment properties under U.S. GAAP and IFRSs would remain.

## RIPE for Change

### FASB Proposes ASU Requiring Fair Value Measurements for Investment Property Entities

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On October 21, 2011, the FASB issued a [proposed ASU](#)<sup>1</sup> that would require investment property entities (IPEs), a newly defined type of entity under U.S. GAAP, to measure their investment properties at fair value through earnings in each reporting period.

The FASB cites two reasons for issuing the proposed ASU. First, the proposed ASU addresses diversity in practice in how real estate entities account for their investments — some record changes in fair value through earnings, while others apply a historical (depreciated) cost model.<sup>2</sup> Second, the proposed ASU would more closely align the accounting for investment properties under U.S. GAAP with that under IFRSs; thus, the proposal could potentially help align the scopes of the FASB's and IASB's proposed lessor accounting requirements.<sup>3</sup>

Comments on the proposed ASU are due by January 5, 2012.

**Update — December 9, 2011:** At its meeting yesterday, the FASB extended the comment letter deadline to February 15, 2012.

**Editor's Note:** Although the proposed ASU constitutes part of the FASB's effort to more closely align U.S. GAAP with IFRSs, fundamental differences in the accounting for investment properties under the two sets of standards would remain. Unlike IAS 40,<sup>4</sup> which gives entities a fair value **option**, the proposed ASU would **require** that investment properties held by an IPE be measured at fair value in each reporting period. In addition, the FASB's guidance only applies to investment properties held by IPEs (the scope of IAS 40 is not limited to such entities). See the [appendix](#) for a summary of differences between IAS 40 and the proposed ASU.

<sup>1</sup> FASB Proposed Accounting Standards Update, *Investment Property Entities*.

<sup>2</sup> The proposed ASU states that "[s]ome real estate entities currently measure their real estate investments at fair value because (1) they have determined that they are investment companies in accordance with Topic 946, (2) they are controlled by pension plans that are required to measure their investments at fair value, or (3) the development of industry accounting practices allows them to measure real estate investments at fair value without regard to investment company attributes or pension plan ownership."

<sup>3</sup> The proposed ASU states that "[a]s part of the FASB's and the International Accounting Standard Board's (IASB) joint project on accounting for leases, the IASB decided that a lessor of an investment property would not be required to apply the proposed lessor accounting requirements in the IASB's August 2010 Exposure Draft, *Leases*, if the lessor measures its investment properties at fair value by electing the fair value model under IAS 40. . . . That would result in significant differences in the scope of entities applying the proposed lessor accounting model under U.S. GAAP and IFRSs [because there is no guidance in U.S. GAAP that is similar to IAS 40]." On October 19, 2011, the FASB and IASB tentatively decided that a lessor's lease of investment property would not be within the scope of the receivable and residual approach, regardless of whether the lessor (1) is within the scope of the proposed IPE ASU or (2) applies the fair value model under IAS 40.

<sup>4</sup> IAS 40, *Investment Property*.

## Overall Guidance and Scope

The proposed ASU defines investment property as “[r]eal estate property, including any **property improvements or integral equipment**, held by an [IPE] (within the scope of Topic 973) for investing purposes rather than for either of the following purposes:

- 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.”

**Editor’s Note:** A property leased to an IPE can qualify as investment property. An IPE with leased investment property would measure the right-of-use asset (that would be created by the FASB’s proposed leasing standard) at fair value through earnings.

Under the proposed ASU, an entity that meets all of the following criteria (discussed in more detail below) is an IPE and is required to measure investment properties at fair value through earnings in each reporting period:

1. *Nature of the business activities.* Substantially all of the entity’s business activities are investing in a real estate property or properties.
2. *Express business purpose.* The express business purpose of the entity is to invest in a real estate property or properties for total return including 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 do 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.
3. *Unit ownership.* Ownership in the entity is represented by units of investments, in the form of equity or partnership interests, to which a portion of the net assets are attributed.
4. *Pooling of funds.* The funds of the entity’s investors are pooled to avail the investors of professional investment management. The entity has investors that are not related to the parent (if there is a parent) and those investors, in aggregate, hold a significant ownership interest in the entity.
5. *Reporting entity.* The entity provides financial results about its investing activities to its investors. The entity can be but does not need to be a legal entity.

**Editor’s Note:** The IPE criteria above are derived from the investment company criteria in ASC 946.<sup>5</sup> The FASB is also proposing certain amendments to the investment company criteria as part of a separate proposed ASU (see Deloitte’s October 21, 2011, [Heads Up](#) for more information). An entity that invests in a real estate property or properties but that does not meet the proposed IPE criteria may still be within the scope of the proposed investment company ASU, in which case it would be required to measure investments owned by the entity at fair value, including investments in investment properties. Because of the similarities between the IPE project and the investment company project, the FASB recommends that the two proposed ASUs be reviewed concurrently. To facilitate comparison, the FASB has decided that the comment periods for the two standards will coincide.

## Nature of Business Activities

Under the proposed ASU, “[s]ubstantially all of the entity’s business activities should be investing [directly or indirectly through a controlling financial interest]<sup>6</sup> in a real estate property or properties.” In other words, an IPE “should not hold significant assets or liabilities other than those relating to its investment(s) in a real estate property or properties.” The proposed ASU highlights that in assessing whether it meets this criterion, an entity should not consider investments in mortgage receivables and mortgage-backed

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<sup>5</sup> For titles of FASB Accounting Standards Codification (ASC) references, see Deloitte’s [“Titles of Topics and Subtopics in the FASB Accounting Standards Codification.”](#)

<sup>6</sup> Controlling financial interest includes an interest held by an entity that is the primary beneficiary of a variable interest entity.

securities to be investments in real estate properties. Noncontrolling investments (e.g., equity method investments) are also not considered investments in real estate properties under this criterion.

**Editor’s Note:** Activities associated with services that relate only to the IPE’s own investment activities (e.g., property management services), even if those activities are significant, do not disqualify the entity from meeting the criterion for the nature of business activities.

## Express Business Purpose

To meet this criterion, an entity must make an express commitment to its investors or potential investors that its business strategy is “to invest in a real estate property or properties to maximize total return, including an objective to realize capital appreciation.” The proposed ASU points out that an entity would fail to meet this criterion if the real estate property is held for (1) the entity’s “own use in the production or supply of goods or services or for administrative purposes” or (2) “[d]evelopment for sale in the ordinary course of business upon completion.” The entity can demonstrate its express business purpose by informing investors about its investment objectives in its offering memorandum, publications, and other corporate or partnership documents.

An entity’s express business purpose is also demonstrated by its investment plans; thus, an entity should “have an exit strategy to dispose of its property . . . to realize capital appreciation to maximize total returns” for its investment properties. However, an IPE is not required to determine the specific method and timing for disposing of the investment property. Disposal of an investment property only through a liquidation process or to satisfy investor redemptions does not qualify as an exit strategy.

**Editor’s Note:** Entities that develop properties to sell them “in the ordinary course of business upon completion,” such as home builders and land developers, are outside the scope of the proposed ASU because the Board believes that such entities should measure their properties in the same manner as manufacturers measure their inventories (i.e., at cost).

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## Unit Ownership

For an entity to meet this criterion, investors must acquire units of ownership, “in the form of equity or partnership interests, in the entity.” The proposed ASU specifies that although each ownership unit represents “a specifically identifiable portion of the net assets of the [IPE],” it “does not have to represent a proportionate interest in all” of the entity’s underlying investments. In addition, an IPE is not precluded from having multiple classes of equity instruments (e.g., preferred shares).

## Pooling of Funds

This criterion requires that an IPE have investors that (1) “are not related to the entity’s **parent** (if there is a parent)” and (2) “hold a significant ownership interest in the entity” in the aggregate (emphasis added). Under this criterion, the parent and its related investors are treated as a single investor. Further, when a parent or its related parties enter into an implicit or explicit arrangement that would require them to acquire another investor’s ownership interests, “those investments should be combined and treated as if they were owned by the parent.”

**Editor’s Note:** The proposed ASU states that an entity that does not meet the criteria related to unit ownership and pooling of funds would still be within the scope of the IPE guidance if the entity’s parent is required to account for its investments at fair value (e.g., the parent is an IPE or a pension plan) or is a not-for-profit entity that would measure its investment at fair value in accordance with ASC 958.

## Reporting Entity

This criterion specifies that an IPE can, but does not need to, be a legal entity. An entity should evaluate its economic substance, rather than its legal form, to determine whether it is “a reporting entity that provides investors with periodic financial results.”

## Measurement of Investment Properties

An investment property acquired outside of a business combination by an IPE is initially measured at the transaction price plus transaction costs. This differs from the requirement in ASC 805 under which transaction costs must be expensed in a business combination. After the acquisition, an IPE’s investment properties must be measured at fair value, with changes in fair value recognized in earnings.

**Editor’s Note:** Assets of an IPE that do not qualify as an investment property would be measured in accordance with other GAAP (e.g., corporate headquarters used for administrative purposes). Debt of an IPE is measured in accordance with other GAAP. Typically, debt is measured at amortized cost, unless an entity elects the fair value option in ASC 825.

## Other Investments

An IPE would apply the consolidation guidance in ASC 810 to the following interests:

- A controlling interest in another IPE or an investment company, as defined in ASC 946.
- A controlling interest in an operating entity that provides services to the IPE parent (e.g., a property management service company).

An IPE that consolidates another IPE or an investment company, as defined in ASC 946, would retain the IPE’s or investment company’s specialized accounting. All other controlling interests in entities would not be consolidated; instead, such interests would be measured at fair value through earnings in each reporting period.

An IPE would apply the equity method of accounting prescribed in ASC 323 only to an investment in an operating entity that provides services to the IPE for which it has significant influence (e.g., property management services). Any other investment (e.g., an investment in an IPE or an investment company) for which the IPE has significant influence would be measured at fair value, with all changes in fair value recognized through earnings in each reporting period.

Investments in loans, debt securities, and cost method investments would be accounted for under other GAAP.

## Rental Revenue Recognition

An IPE would recognize rental revenue from its investment properties “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 basis.

## Presentation and Disclosure

The proposed ASU also prescribes certain presentation and disclosure requirements for an IPE. An IPE would be required to separately present within the income statement all of the following related to its investment properties: (1) rental revenues, (2) rental operating expenses, and (3) changes in fair value recognized in earnings. In addition, an IPE would separately present, within the statement of financial position, the (1) fair value of investment properties held and (2) any debt associated with the investment properties.

Assets of an IPE that do not qualify as an investment property would be measured in accordance with other GAAP.

The proposed ASU would require an IPE to provide the following disclosures (in addition to disclosures required by other applicable GAAP):<sup>7</sup>

- a. The amounts recognized in net income for direct operating expenses, separately for investment properties that generated rental revenue during the period and investment properties that did not generate rental revenue during the period.
- b. Any restrictions on the ability to increase rent, collect rental revenue, or collect proceeds on the sale of an investment property.
- c. Any contractual obligations related to an investment property.

Lastly, an entity with a change in status (e.g., from non-IPE to IPE or vice versa) would be required to disclose that a change in status occurred and the reasons for that change. An entity that becomes an IPE must disclose the effect of the change in status on (1) the reported amount of investment properties and (2) net income for the current period.

## Effective Date and Transition

The proposed ASU does not specify an effective date. The Board will set the effective date after considering comment letter feedback on the proposed ASU. Early application would be prohibited.

An entity that would be an IPE as a result of the proposed ASU would report the effect of applying the amendments in the proposed ASU as a cumulative-effect<sup>8</sup> adjustment to retained earnings as of the beginning of the period of adoption.

<sup>7</sup> For example, an IPE would be required to provide the fair value measurement disclosures required by ASC 820.

<sup>8</sup> The proposed ASU indicates that the “cumulative-effect adjustment is the difference between the amounts recognized in the statement of financial position [or similar statement] before initial application and the amounts recognized in the statement of financial position [or similar statement] immediately after initial application.”

## Appendix — Differences Between the Proposed ASU and IAS 40

The table below summarizes differences between the proposed ASU and IAS 40.

Provisions	Proposed ASU	IAS 40
Scope	All investment properties that are controlled directly or indirectly through an entity by an IPE must be measured at fair value. Only an IPE (or an investment company) can measure investment properties at fair value through earnings in each reporting period.	An entity has the option of measuring its investment properties at fair value. Any entity can elect this option for all of its investment properties.
Revenue recognition	Rental revenue is recognized “when lease payments are received or as the lease payments become receivable in accordance with the contractual terms of the related lease.”	Rental revenue is recognized on a straight-line basis.
Definition of an investment property	Generally consistent with the definition of investment property in IAS 40, except that a part of a building cannot be designated as an investment property.	IAS 40 defines investment property as “property (land or a building — or part of a building — or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:  (a) use in the production or supply of goods or services or for administrative purposes; or  (b) sale in the ordinary course of business.”
Fair value expedient	No practicability exception is provided for fair value measurement of investment properties.	A practicability exception is provided for fair value measurements of investment properties if fair value cannot be reliably measured (e.g., for investment properties under construction).
Interest in other entities	The consolidation requirements in ASC 810 only apply to an IPE’s controlling interest in another IPE, an investment company, or an operating entity that provides services to the IPE. All other controlling interests in entities would not be consolidated; instead, such interests would be measured at fair value through earnings in each reporting period.  The equity method guidance in ASC 323 only applies to an operating entity that provides services to the IPE. All other interests for which the IPE has significant influence are measured at fair value through earnings in each reporting period.	No exceptions to the consolidation requirements in IFRS 10 <sup>9</sup> and the equity method guidance in IAS 28. <sup>10</sup>

<sup>9</sup> IFRS 10, *Consolidated Financial Statements*.

<sup>10</sup> IAS 28, *Investments in Associates and Joint Ventures*.

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