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Proposed Accounting Standards Update: Real Estate--Investment Property Entities (Topic 973)

The Accounting Principles and Auditing Standards Committee ("the Committee" or "We") of the California Society of Certified Public Accountants ("CalCPA") is grateful for the opportunity to comment on the Proposed Accounting Standards Update referenced above. The Committee is the senior technical committee of CalCPA. CalCPA has approximately 35,000 members. The Committee is comprised of 43 members, of whom 56 percent are from local or regional firms, 21 percent are from large multi-office firms, 12 percent are sole practitioners in public practice, 9 percent are in academia and 2 percent are in an international firm.

The Committee generally supports the changes in this Proposed Accounting Standards Update, but some members of the Committee take issue with some of the proposed changes, as indicated in our responses to the specific questions below.

Question 1: 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.

The Committee believes that an entity that is an investment property entity (IPE) should measure investment properties at fair value. The Committee believes that the accounting should be driven by the nature of the transaction and not by the form of the entity. Accordingly the Committee believes that entities that are not IPEs should have the option to measure investment properties at fair value, and the Committee recommends, if this proposed ASU is adopted, that the Board undertake to make changes to the accounting literature to extend the fair value option to all other entities in manner consistent with IAS 40. This would have the added benefit of reducing the differences between this standard and the IASB standard.

Question 2: 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.

Fair value should be required to provide consistent accounting among and between the same transactions. This should not be an option,

Question 3: 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?

The Committee believes that they are appropriate. Further, consistent with our answer to Question 1 above, all entities measuring their real estate properties at fair value should be excluded from the scope of the lessor accounting model in the proposed Update on leases.

Question 4: 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?

The Committee believes that it is appropriate.

Question 5. 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.

There is an inevitable overlap in the definitions of an investment property entity and an investment company. Since the basic accounting for both investment companies and IPEs is fair value, and accounting for interests in other entities is very similar, it would seem the better course to require the same basic accounting for both types of entities, and publish it as a single section in the accounting standards supplemented with specific requirements for accounting for investment properties and specific requirements for noninvestment property activities where the accounting for each type of entity differs. If an entity has investment properties, it would apply the fair value approach and the specific requirements for investment properties.

Nature of the Business Activities

Question 6: 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.

A majority of the Committee believes that it should be so limited.

A significant number of members of the Committee believes that limiting IPE status to entities substantially all of whose assets are real properties would result in precluding many entities that should use fair value accounting from using it. (See our answer to Question 1 above) Also, a significant portion of investment property activity is often in real estate assets other than whole real estate investment properties. For example distressed mortgages may be purchased as a means to acquire distressed properties or to benefit from their recovery, or an entity may take back a receivable on sale of property. Also real estate entities often invest in real estate joint ventures and minority interests or other fractional interests in properties. These Committee members believe it is just as appropriate to account for such assets at fair value as it is to account for entire interests in real property. Such entities should not be forced to turn to investment company accounting with its specialized rules concerning control matters to be able to utilize fair value accounting.

Question 7: 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?

As indicated in our answer to Question 6 above a majority of the Committee agrees with the implementation guidance that indirectly held properties should not be considered when evaluating whether substantially all of the parent's business activities are investing in real estate. A significant number of members of the Committee disagrees, believing that investing in non-controlled real estate assets is part of the normal business activities of many real estate entities.

Express Business Purpose

Question 8: 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.

The Committee believes that the criteria stated above are appropriate and operational.

Question 9: 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.

The Committee believes that an exit strategy should not be required and notes that it is not required for investment companies. We believe that such exit strategies are implicit in the process of earning income through capital appreciation or collection of rental income and eventual sale of real estate investment properties.

Unit Ownership and Pooling of Funds

Question 10: 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?

The Committee agrees with the Board's proposal.

Question 11: 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?

The Committee agrees with this provision.

Measurement

Question 12: 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?

The Committee believes that real estate properties other than investment properties are by definition not being held for capital appreciation or investment income and are therefore properly excluded from fair value measurement.

Question 13: 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?

The Committee agrees with the Board's proposal.

Interests in Other Entities

Question 14: 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?

The Committee agrees with the Board's proposal that an IPE should consolidate controlling financial interests in these entities, and not consolidate controlling financial interests in other entities, because they agree with the requirement to measure only investments and investment properties at fair value, and not other real estate. Real estate assets not measured at fair value should not be consolidated with assets that are not measured at fair value.

Question 15: 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?

The Committee agrees with prohibiting application of the equity method unless the investee is an operating company that provides services to the IPE.

Question 16: 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?

A majority of the Committee agrees with the proposed amendments. A significant number of Committee members believe that investments where there is no significant influence and the investee is engaged in investment entity activities should also be measured at fair value, and that fair value also be used to measure real estate related receivables.

Financial Liabilities

Question 17: 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?

The majority of the Committee favors measuring real estate related debt at fair value finding it difficult to reconcile applying fair value to assets without applying fair value to related liabilities. A significant number of Committee members oppose measuring debt at fair value and generally cite their opposition to increasing or reducing an entity's net worth through revaluation of its debt.

Rental Revenue Recognition

Question 18: 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?

The Committee agrees with the Board's proposal.

Practical Expedient for Measurement of an Interest in an Investment Property Entity

Question 19: 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.

The Committee is unaware of any investments that currently qualify for the practical expedient that would no longer qualify under the Board's proposal.

Disclosure

Question 20: 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?

The Committee believes that the proposed disclosures are appropriate.

Effective Date and Transition

Question 21: 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?

The Committee does not object to the proposed transition provisions.

Question 22: How much time would be necessary to implement the proposed amendments?

The Committee believes that most IPE's know the fair value of their properties. Most of the implementation process would involve preparing satisfactory audit evidence, a process which would not be expected to take an inordinate amount of time.

Question 23: The proposed amendments would prohibit early adoption. Should early adoption be permitted? If yes, why?

The Committee agrees with the prohibition against early adoption. Some members believe however, that entities who wish to disclose fair value data prior to the effective date should follow the provisions of the Update.

Nonpublic Entities

Question 24: 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?

The Committee believes that the issue of whether the proposed amendments should be applied to private companies should be resolved as part of current issues about how GAAP should be set for public and private companies. A significant number of members believe that if this is impractical, the Board should apply the provisions to private companies with a delayed effective date because of the steep learning curve and costs that these entities may incur.

We would be glad to discuss our opinions with you further should you have any questions or require additional information.

Sincerely,

A handwritten signature in black ink that reads "Howard Sibel". The signature is written in a cursive, flowing style.

Howard Sibelman
Chair
Accounting Principles and Auditing Standards Committee
California Society of Certified Public Accountants