



cutting through complexity

Real estate accounting and reporting: The impact of new standards and guidance

Winter 2013-2014

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As a leader in real estate financial reporting, KPMG LLP (KPMG) has created this document—the first in an ongoing series—to assist real estate companies and funds with their 2013 financial accounting, regulatory, and compliance reporting requirements.

In addition to the technical guidance on current requirements, we also discuss forthcoming accounting rules that will continue to challenge and improve upon existing GAAP requirements, as well as offer some brief insight on the current regulatory environment facing our marketplace. And, to provide some overarching context, we begin the document with some brief commentary from Constance Hunter, KPMG's Alternative Investments chief economist.

This document provides a very focused and relevant look at the key issues you will face, and broad guidance on how to address these issues most effectively. Of course, we would be happy to discuss your specific situations or objectives in more detail.

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Economic update: Kicking the can (again)

Economic outlook in the wake of a mini-deal in Washington:



Constance Hunter,
KPMG's Alternative
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Chief Economist

The President and Congress have staved off disaster by kicking the can down the road past the New Year. This means on every street corner, holiday shoppers will not just hear "Silver Bells"; they will also hear continued rancor from Washington over the debt ceiling and the continuing resolution. The timing is such that the continuing resolution deadline on January 15, 2014, comes before the debt ceiling deadline on February 7, 2014. While both sides are quick to say they want to avoid another shutdown, ideological approaches remain far apart and we would not be surprised to see a continuing resolution come down to the wire.

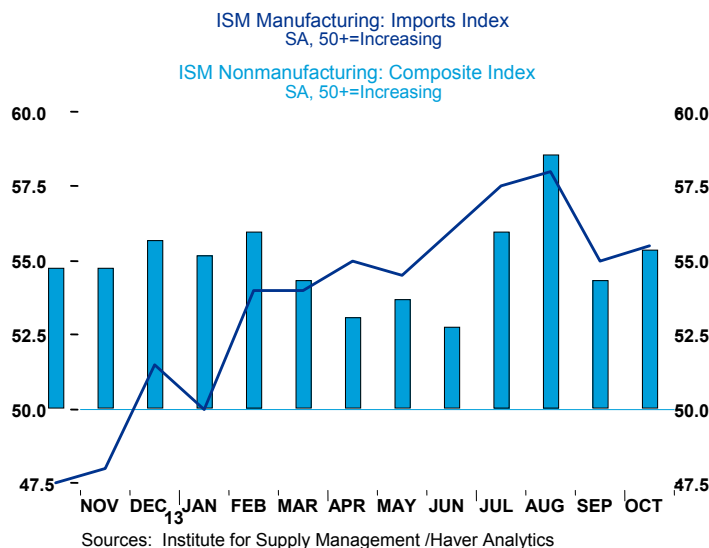
The economic shutdown in October depressed that month's output. Some of that output will return, and furloughed workers will receive their back pay and resume their normal spending patterns. However, for businesses which are tangentially linked

to the government, such as the tour operators in federal parks that did not receive—and will never receive—income during the three weeks the government was closed, there will only be a limited bounce-back in spending. Finally, there is the long-term impact of U.S. standing in the world as we had to halt negotiations on two major trade deals, the Trans-Pacific Partnership (TPP) with the Association of Southeast Asian Nations (ASEAN) and the Transatlantic Trade and Investment Partnership (TTIP) with Europe, during the shutdown. In total, the impact of the shutdown is likely to be between 20 and 30 basis points of GDP, taking our Q4 GDP estimate from 2.4 percent down to 2.1 – 2.2 percent in quarterly growth.

It is also important to remember that, going into Q4, the economy had steady momentum. While inventory-building contributed an unusual 80 basis points to the 2.8% growth rate in Q3, so a downward revision may occur when the trade data comes in, we are still tracking close to the 2.5% level seen in Q2.

We should note that the US economy is resilient and, while 2.5% would once have not been considered lift velocity, we seem to be sustaining a positive, if somewhat low, growth trajectory. The latest purchasing manager surveys are firmly above the 50 mark that suggests a positive growth outlook. (See accompanying graph.)

Nevertheless, concerns over lift velocity and the inability of Congress to seal a budget deal caused the Federal Reserve to continue its purchases of Treasuries and mortgage-backed paper. This is arguably a strategy with diminishing marginal returns. The impact on financial markets is not as straightforward, which can be seen in the bond market; the weighted index of implied volatility on one-month treasury options has been elevated since June, suggesting that market participants are uneasy about the timing and magnitude of tapering. The sooner Congress passes a continuing resolution to fund the government, the sooner the Fed can begin to taper.





New standards and guidance

“Investment company” defined

In June 2013, the FASB revised the conditions necessary to apply specialized fair value accounting and reporting for investment companies.¹ While all real estate (and other) entities, except for real estate investment trusts (REITs) and entities regulated under the Investment Company Act of 1940, need to determine if they meet the criteria to apply investment company accounting, the FASB indicated the new guidance is not intended to change industry practice for real estate funds reporting their investments at fair value. This includes entities that have historically reported under the Real Estate Information Standards (REIS) standards issued by National Association of Real Estate Investment Fiduciaries (NCREIF). While real estate funds reporting as investment companies need to determine if they continue to meet that definition under the new criteria, we do not believe most entities will become ineligible for “investment company” accounting and reporting.

The new standard requires additional disclosures about an entity’s status as an investment company, any changes to that status, and information about financial support provided to an investee.

The new guidance is effective for interim and annual reporting periods in fiscal years beginning after December 15, 2013. Early application is prohibited.

WHAT’S AN INVESTMENT COMPANY?

Fundamental (required) characteristics:

- Provides investment management services
- Business purpose – investing for investment income and/or capital appreciation
- No operating/strategic benefits

Other typical characteristics:

- Multiple investments
- Multiple investors
- External (unrelated) investors
- Ownership interests
- Fair value management

¹ FASB Accounting Standards Update No. 2013-08, Financial Services – Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements, available at www.fasb.org.

FASB allows fed funds rate for hedge accounting

Since July 17, 2013, entities have been able to designate the Fed funds rate as a benchmark interest rate for new hedging relationships.² Following the 2008 financial crisis, U.S. banks making markets in interest rate derivatives have been increasingly focused on indexing and valuing those derivatives consistently with their funding sources. Including the Fed funds rate as a benchmark rate gives real estate companies more options for applying hedge accounting to their fixed- or variable-rate debt. This may be helpful when financing options and derivatives based on the Fed funds rate are more available and cost-effective than their London Interbank Offered Rate (LIBOR) counterparts.

The FASB also decided to remove the requirement that the same benchmark interest rate be used for similar hedges. However, companies are still generally expected to use the same method of assessing effectiveness for similar hedges.

What is the Fed funds rate?

The federal funds rate is the negotiated interest rate at which depository institutions actively trade balances held at the Federal Reserve with each other, usually overnight, to meet reserve requirements. The weighted average of this rate is the overnight Fed funds effective rate. The related overnight index swap (OIS) rate is the fixed rate swapped in exchange for the overnight Fed funds effective rate.

Joint and several liability arrangements

A recently issued accounting standard requires entities to record obligations under joint and several liability arrangements at the greater of the amount they have agreed to pay or the amount they expect to pay, unless specific guidance currently exists for the obligation under U.S. GAAP (e.g., contingencies, environmental remediation, and tax liabilities).³

Under joint and several liability arrangements, a creditor can demand payment of the total amount of the obligation from any one of the obligors or any combination of the obligors. These arrangements are common in joint venture agreements. For example, a construction lender to a real estate development joint venture may require the venture partners to guarantee the repayment of the debt on a joint and several basis. This allows the lender to demand full payment of the entire outstanding balance from any one of the individual venture partners. While the paying venture partner cannot refuse to pay, it may have the right to pursue repayment from the other venture partner(s).

The standard is effective for public entities in fiscal years (and interim periods within those years) beginning after December 15, 2013 and is effective for nonpublic entities in fiscal years ending after December 15, 2014. The guidance should be applied on a retrospective basis for obligations that exist at the beginning of an entity's fiscal year of adoption. Early adoption is permitted.

² FASB Accounting Standards Update No. 2013-10, Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes, available at www.fasb.org.

³ FASB Accounting Standards Update No. 2013-04, Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date, available at www.fasb.org.

Liquidation basis of accounting

New guidance issued earlier this year requires entities to prepare financial statements on the liquidation basis of accounting when liquidation is “imminent,” unless the liquidation follows a plan that was specified in the entity’s governing documents.⁴ Liquidation is considered “imminent” when there is a remote likelihood that the entity will return from liquidation and either of the following occurs:

- A plan for liquidation has been approved by the persons with the authority to make the plan effective, and there is a remote likelihood that the execution of the plan will be blocked by other parties; or
- A plan for liquidation is imposed by other forces (e.g., involuntary bankruptcy).

For many limited-life entities, like close-ended real estate funds, a plan of liquidation is specified at inception of the entity in its governing documents. If liquidation is expected to follow that plan, the entity should not apply the liquidation basis of accounting. However, if liquidation is “imminent” and the approved plan differs from the plan specified at inception, the entity is required to apply the liquidation basis of accounting. A plan for liquidation is presumed not to follow the plan specified at inception if the entity anticipates disposing of its assets at an amount other than fair value.

An entity applying the liquidation basis measures its assets at the estimated amount of cash (or other consideration) it expects to collect and its liabilities at the amount otherwise prescribed under U.S. GAAP. The entity also accrues costs that it expects to incur and revenues that it expects to earn during the liquidation period, including costs related to the sale or settlement of its assets and liabilities. Liquidation-basis financial statements must include at least a statement of net assets in liquidation, a statement of changes in net assets in liquidation, and specified minimum disclosures.

The standard is effective during annual reporting periods beginning after December 15, 2013 and applies to all entities except for investment companies regulated under the Investment Company Act of 1940.

Valuing private company equity-based compensation

The American Institute of Certified Public Accountants issued a practice aid addressing the valuation of privately-held-company equity securities issued as compensation (the Practice Aid).⁵ The Practice Aid addresses a number of issues including:

- Measuring privately-held-company equity securities issued as compensation at fair value⁶
- Considerations for determining the appropriate basis of valuation
- Leading practices for estimating fair value
- Factors to consider for determining control and marketability adjustments
- How to consider private and secondary market transactions in the valuation process
- Possible disclosures in the financial statements and Management’s Discussion and Analysis (MD&A).

The Practice Aid is nonauthoritative and specifically intended for valuing minority equity interests in privately held companies for share-based compensation purposes. However, its guidance is also likely to be used in practice for other valuation purposes.

⁴ FASB Accounting Standards Update No. 2013-07, Liquidation Basis of Accounting, available at www.fasb.org.

⁵ The AICPA’s Accounting and Valuation Guide: Valuation of Privately-Held-Company Equity Securities Issued as Compensation, supersedes the 2004 Practice Aid, Privately-Held-Company Equity Securities Issued as Compensation (2004 Practice Aid), historically referred to as the “Cheap Stock Guide.” The new Practice Aid is nonauthoritative and was developed by the AICPA staff and the AICPA Equity Securities Task Force and is available for purchase at www.aicpa.org.

⁶ FASB ASC Topic 820, Fair Value Measurement, available at www.fasb.org.



Proposed standards and guidance

Investments in affordable housing tax credits

The Low-Income Housing Tax Credit (LIHTC) is a program designed to encourage investment in the construction and rehabilitation of low-income housing. The program provides a tax credit to investors in entities that own and operate qualified affordable housing projects. While affordable housing projects generally incur pretax book losses after considering the effects of depreciation, investors expect a positive return when considering the tax credits and other tax benefits, such as tax deductions from the project's operating losses. Many affordable housing projects developed and operated by real estate companies rely on the capital provided by tax-credit investors and availability of that capital may be influenced by the accounting treatment afforded to those investments.

The Emerging Issues Task Force (EITF) tentatively agreed at its September meeting to allow certain LIHTC investors to treat the investments like a purchase of tax benefits and apply a proportional amortization method for subsequent measurement under which the amortization of the cost of the investments would be presented in income tax expense along with the related tax benefits. The EITF tentatively agreed that the unamortized cost of the investments would be presented with deferred tax assets on the balance sheet. The cost of the investments would be amortized in proportion to (and over the same period as) the total expected tax benefits (credits and other tax benefits, like the benefits generated from the LIHTC project's operating losses). Investors would evaluate impairment based on whether the tax benefits are more likely than not to be realized.

Investors would be able to apply the proportional amortization method to their LIHTC investments as an accounting policy election only if certain criteria are met (see criteria below). If an investor does not qualify for the proportional amortization method (or does not elect it), it would account for its investment under the equity or cost method based on existing U.S. GAAP.

Before reaching a final consensus, the EITF asked the FASB staff to (a) obtain input from constituents before the November 14 meeting on the decisions reached at the September meeting, and (b) research whether the proportional amortization method also should be available to investors in other tax credit arrangements. The FASB staff also was asked to analyze, based on the EITF's tentative agreement, whether reexposure would be necessary.

The tentative agreements would change the current effective yield model under EITF Issue 94-1.⁷ Investors currently electing the effective yield method record the amortization of the investment and the tax benefits in income tax expense using a constant effective yield. The criteria to elect the effective yield method require that the availability of the tax credit allocable to the investor be guaranteed by a creditworthy entity and that the yield based solely on the guaranteed tax credits is positive. Few current LIHTC investments meet these criteria.

LIHTC investors would be permitted to apply the proportional amortization method only if:

- (a) It is probable that the tax credits will be available
- (b) They do not have significant influence over operating and financial policies of the investee, and substantially all of the projected benefits are from the tax credits and other tax benefits
- (c) The investors' expected return is positive, based solely on the cash flows from the tax credits and other tax benefits
- (d) They hold a limited interest (LP or LLC) in the affordable housing project for both legal and tax purposes, and their liability is limited to their capital investment.

⁷ FASB EITF Issue No. 94-1, Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects, which was codified in FASB ASC Subtopic 323-740, available at www.fasb.org.



FASB proposes reporting less discontinued operations

The FASB recently proposed to limit discontinued operations presentation to disposals of separate major lines of business or separate major geographical areas and eliminate the continuing investment test. Significantly fewer disposals of real estate properties would qualify for presentation as discontinued operations under the proposal as compared to current U.S. GAAP. The proposed discontinued operations definition would also substantially converge U.S. GAAP with IFRS.^{8,9} Companies also would be required to disclose material components disposed of and held for sale that do not qualify as discontinued operations.

The comment period for this proposed guidance ended August 30, 2013.

Proposed changes to VIE and non-VIE consolidation guidance

In November 2011, the FASB proposed to change the way entities evaluate consolidation of variable interest entities (VIEs), non-VIE partnerships, and similar entities. The proposal would require an organization to determine if it has power to direct the activities of another entity in the capacity of a principal or an agent.¹⁰ Organizations that have power in the capacity of an agent would not be required or permitted to consolidate the entity over which they have power. The proposal would also eliminate differences in how participating rights and kick-out rights are evaluated for VIEs versus non-VIEs. For example, currently, a general partner is presumed to control (and must consolidate) a non-VIE partnership unless the limited partners have certain “substantive” participating or kick-out rights. To be considered substantive, the rights must be exercisable by a simple majority of the limited partners that are not related parties of the general partner and other conditions must be met. However, if that same partnership were a VIE, the rights would not be considered substantive if a simple majority of the limited partners must agree to exercise them.

In its last meeting to discuss this proposed standard in November 2012, the FASB decided to align the principal-agent analysis for VIEs and non-VIE partnerships by requiring a decision maker that is determined to be the principal of the entity to consolidate it.

The project has been delayed and the FASB now expects to issue its final standard in the second half of 2014.

To push-down or not to push-down

Under “push-down accounting,” an acquirer pushes down its new fair value basis in the acquiree to the acquiree’s separate financial statements. The SEC staff requires registrants to apply push-down accounting when the noncontrolling interest is 5 percent or less and permits push-down accounting when the noncontrolling interest is between 5 percent and 20 percent. Current U.S. GAAP, however, provides limited guidance for determining when, if ever, push-down accounting should, or can, be applied. At its March 2013 meeting, the EITF requested that the FASB staff perform additional research on issues that could result from requiring push-down accounting upon a change in control.¹¹ The EITF also intends to consider whether push-down accounting should be required or optional at different levels of changes in ownership. The issue will be discussed at a future meeting.

Example: Applying push-down accounting

REIT acquires a controlling financial interest in ABC LLP, a nonpublic entity that owns operating real estate properties. At acquisition, REIT recognizes and measures the assets and liabilities of ABC in its consolidated financial statements at fair value. ABC continues to issue stand-alone financial statements to its lenders. Current U.S. GAAP does not address if ABC should reflect REIT’s fair value basis in its stand-alone financial statements (i.e., if push-down accounting should be applied). If ABC was a public company and REIT acquired 95 percent or more of ABC, push-down accounting would be required in ABC’s stand-alone financial statements (push-down accounting would be permitted if REIT acquired between 80 percent and 94 percent of ABC). The EITF is considering whether push-down accounting should be required and/or permitted under U.S. GAAP upon a change in control at different levels of ownership.

Proposed going concern standard isn’t all about substantial doubt

A recent FASB proposal would provide guidance in U.S. GAAP on when and how entities should disclose going concern uncertainties in financial statements.¹² All entities would be required to assess at each reporting period their ability to meet their obligations as they become due within 24 months of the

⁸ Proposed FASB Accounting Standards Update, Reporting Discontinued Operations, available at www.fasb.org.

⁹ IAS 36, Impairment of Assets, and IFRS 5, Non-current Assets Held for Sale and Discontinued Operations.

¹⁰ FASB Proposed Accounting Standards Update, Principal versus Agent Analysis, November 3, 2011, available at www.fasb.org.

¹¹ FASB EITF Issue No. 12-F, Recognition of New Accounting Basis (Push-down) in Certain Circumstances.

¹² FASB Proposed Accounting Standards Update, Disclosure of Uncertainties about an Entity’s Going Concern Presumption, June 26, 2013, available at www.fasb.org.

financial statement date. Disclosures addressing going concern uncertainties would be required if it is (a) more likely than not (i.e., greater than 50 percent) that the entity will be unable to meet its obligations within 12 months after the financial statement date without taking actions outside the ordinary course of business or (b) known or probable that the entity will be unable to meet its obligations within 24 months after the financial statement date without taking actions outside the ordinary course of business. Real estate companies with continuous mortgage (or other debt) maturities that plan to refinance will be particularly interested in how “outside the ordinary course of business” is defined because those plans cannot be considered in evaluating the need for disclosure.

An SEC filer also would need to evaluate whether there is substantial doubt about its ability to continue as a going concern and, if so, express that conclusion in the financial statements. In evaluating substantial doubt (i.e., whether it is probable the entity will be unable to meet its obligations within 24 months of the financial statement date), management can consider all its plans, even those outside the ordinary course of business. Extending the substantial doubt assessment period from 12 (current auditing standards) to 24 months (the proposed assessment period) could result in different conclusions about the need for going concern explanatory paragraphs in the auditor’s report.

No effective date has been proposed. The comment period closed September 24.



Convergence projects

Revenue recognition

The FASB and the International Accounting Standards Board expect to finalize their revenue recognition standards by the end of 2013.¹³ The FASB standard is expected to be effective for fiscal and interim periods beginning after December 15, 2016 with a one-year deferral for nonpublic entities. The forthcoming standard will eliminate the specific requirements for profit recognition on sales of real estate under current U.S. GAAP, which may result in accelerated revenue (or gains). For construction contracts, recognition of contract revenue and contract costs will be decoupled; smooth margins will only result if an entity determines that a cost-to-cost method most appropriately measures progress toward satisfaction of the performance obligation. Some other areas of particular interest for real estate entities include:

Seller financing

To recognize full profit on a real estate sale under current U.S. GAAP, the buyer must satisfy specified initial and continuing investment requirements and the seller may not have significant continuing involvement. Under the forthcoming standard, collectibility will only be considered in determining whether a contract exists and in valuing the buyer's receivable. If doubts about collectibility cause the seller to conclude that a contract does not exist, it will account for any cash collected as a deposit.

Five-step model to recognize revenue

- Step 1 – Identify the contract with a customer
- Step 2 – Identify the separate performance obligations in the contract
- Step 3 – Determine the transaction price
- Step 4 – Allocate the transaction price to the separate performance obligations
- Step 5 – Recognize revenue when (or as) performance obligations are satisfied

Continuing involvement

Like initial and continuing investments, current U.S. GAAP is very specific about what postsale involvement with the property prevents the seller from either recognizing full profit or taking the property off its balance sheet. Under the forthcoming standard, a seller with continuing involvement will be allowed to recognize profit on a sale when the buyer obtains control of the property, but may need to account for the continuing obligations separately.

Property sales with development contracts

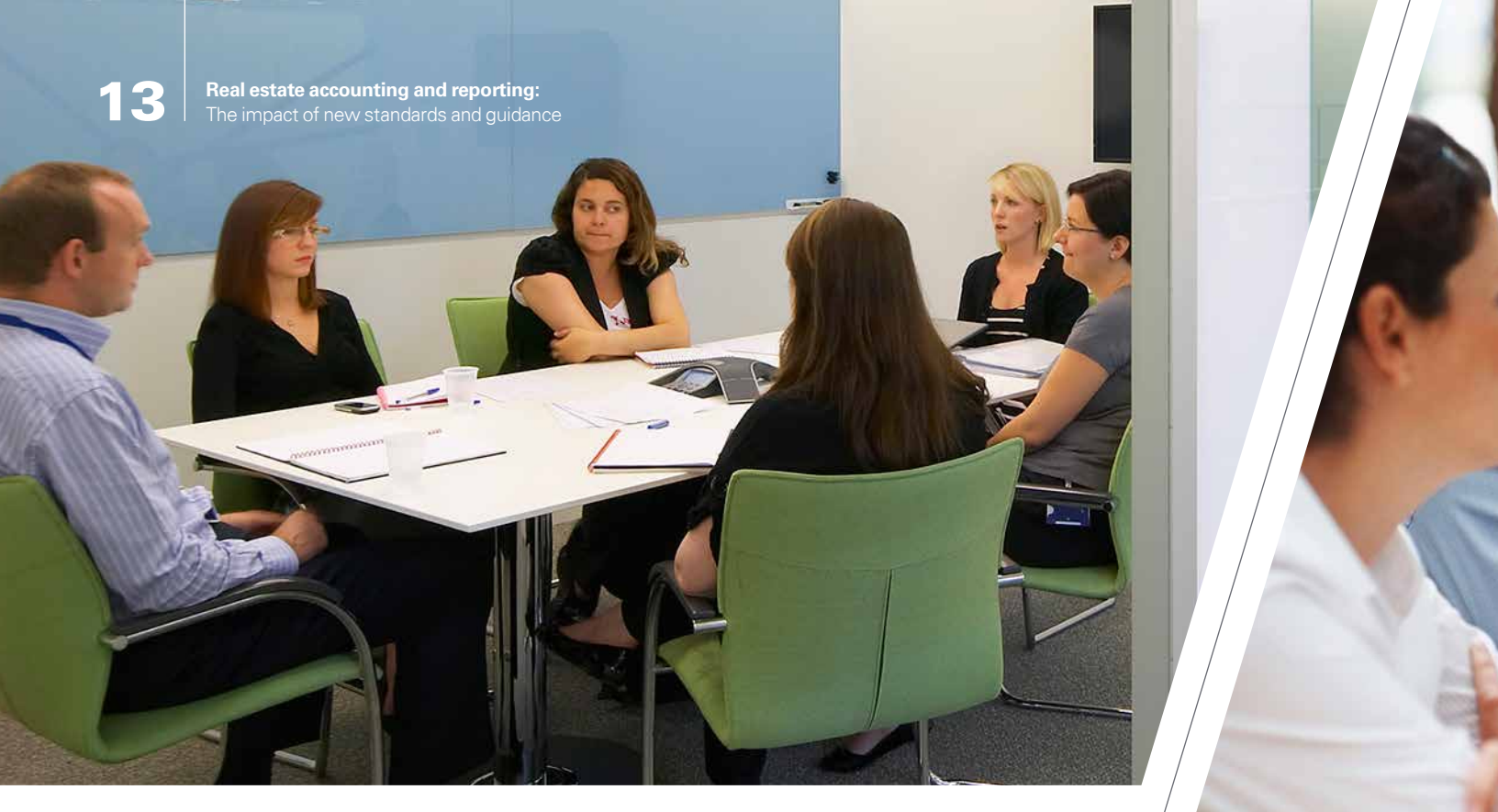
Current U.S. GAAP requires a seller/developer to recognize the same profit margin on the sale of a property and the accompanying development contract (e.g., for future amenities, roads, etc.). That profit is generally recognized as the sale and development are completed. Under the forthcoming standard, the seller/developer will need to determine if the property sale and development contract is one performance obligation or multiple performance obligations. This may cause differences in the amount and timing of revenue recognized on the property sale and the development contract.

Participation in future profits

A seller generally recognizes contingent sales proceeds (e.g., those based on the property's future performance) when realized. The forthcoming standard will require the seller to estimate the future variable payments when recognizing revenue on the sale. However, the seller also will need to limit revenue recognized to the amount that is not susceptible to a risk of significant reversal.

¹³ FASB Proposed Accounting Standards Update, Revenue from Contracts with Customers, November 14, 2011, available at www.fasb.org, and IASB ED/2011/6, Revenue from Contracts with Customers November 2011, available at www.ifrs.org.





Lease accounting

In May 2013, the FASB and IASB released revised exposure drafts on lease accounting that would significantly change current practice.¹⁴

The proposals include a right-of-use model that would require lessees to recognize all leases, other than short-term leases, on their balance sheets. Lessees and lessors would classify leases into one of two types based principally on the nature and extent of the lessee's consumption of the underlying asset.

For most property (i.e., land and building) leases and some equipment leases, lessees would recognize the noncontingent lease expense on a straight-line basis over the lease term, while lessors would apply accounting that is substantially equivalent to current operating lease accounting.

For most equipment leases and some property leases (those where the lease term is for a major part of the remaining economic life of the property and/or the present value of the lease payments represents substantially all of the total fair value of the property), the lessee would account for the lease as a financing and recognize interest and amortization expense in a pattern similar to current U.S. GAAP for capital leases. The lessor would account for these leases similar to current sales-type lease accounting.

Many real estate executives are pleased with the FASB's current direction on lessor accounting for real estate leases because there would be few changes from the accounting under current U.S. GAAP. Initial concerns about the impact of the proposed lessee accounting model and whether it will change real estate lessees' behavior have also subsided; however, there still remains uncertainty on how the lessee accounting model may influence their decision making. At this time, the Boards have yet to consider the feedback received from constituents in over 600 comment letters, which may affect the proposals. As a result, real estate companies will want to continue to monitor the progress of the Boards' deliberations on the project.

The final leases standard is not expected to have an effective date before January 1, 2017, for calendar-year-end companies with an additional one-year deferral for nonpublic entities. The proposals would require that the new accounting be reflected as of the beginning of the earliest comparative period included in the first financial statements issued after the effective date.

¹⁴ FASB Proposed Accounting Standards Update (Revised), Leases, May 16, 2013, available at www.fasb.org, and IASB ED/2013/6, Leases, May 2013, available at www.ifrs.org.



Long-term leases of land only

Long term leases of land are within the scope of the proposed standard. If the present value of lease payments represents substantially all of the fair value of the land at lease inception, the proposed standard would require the lessee to account for the lease like a financing (i.e., recognize interest and amortization expense, similar to current capital lease accounting) and the lessor to account for the lease similar to sales-type lease accounting by derecognizing the land and recognizing a lease receivable (for the right to receive lease payments) and a residual asset.

Short-term leases

Short-term leases (those with a maximum term of 12 months or less) would be accounted for similar to current operating lease accounting.

Classifying and measuring financial instruments

Under the FASB's recent proposal, an entity would classify and measure financial assets based on both the contractual cash flow characteristics of the assets and the entity's business model for managing the assets, rather than on their legal form (e.g., loans or securities). Financial assets would be included in one of three classification and measurement categories: (1) amortized cost, (2) fair value through other comprehensive income, or (3) fair value through net income, while financial liabilities generally would be measured at amortized cost.

Some real estate entities currently elect to measure some or all of their debt instruments at fair value under the fair value option. The current fair value option is a one-time irrevocable election that generally can be applied to most individual financial assets and liabilities.¹⁵ The proposal would limit the fair value option at initial recognition to a group of financial assets and financial liabilities only if both of the following conditions are met:

- The entity manages the net exposure relating to the financial assets and financial liabilities (which may be derivative instruments) on a fair value basis
- The entity provides information on a net exposure basis to its management.

Accordingly, many financial liabilities of real estate entities would not be eligible for fair value measurement as most are not managed or otherwise contractually linked to financial assets.

The FASB expects to issue its final standard in the first half of 2014.

¹⁵ FASB ASC Section 825-10, Financial Instruments, available at www.fasb.org.

New standard-setting initiatives

Private Company Council

The FASB recently issued several proposals recommended by the Private Company Council (PCC). The PCC was established in 2012 to advise the FASB about private company exceptions or modifications to current U.S. GAAP. The recent proposals would allow (but not require) private companies to:

- Include in goodwill certain intangible assets acquired in business combinations (including acquisitions of operating real estate that are considered business combinations) that are currently separately recognized¹⁶
- Amortize goodwill and apply a simplified impairment model¹⁷
- Apply one of two simpler approaches to account for certain types of interest rate swaps that economically convert variable-rate borrowings to a fixed rate
- Not apply current VIE consolidation guidance for certain common control leasing arrangements.¹⁸

These proposals, especially those related to intangible assets and receive variable-pay fixed interest rate swaps, may be of particular interest to private real estate companies as they would ease the burden in applying the acquisition method and cash flow hedge accounting.

The FASB and the PCC also recently voted to finalize the private company decision-making framework. The framework will provide criteria for determining when private company exceptions or modifications to current U.S. GAAP are appropriate to address the needs of financial statement users and to reduce complexity for private company financial statements. The framework is expected to be issued shortly.

Public companies may want to monitor PCC developments because they may ultimately influence future changes to the broader U.S. GAAP requirements.

Definition of a public business entity

The FASB recently issued a proposal that would provide a single definition of a public business entity to apply to future standards issued by the FASB.¹⁹ The proposed definition identifies the types of entities that would not be eligible to use private company exceptions and alternatives issued by the FASB. The proposal would not affect existing requirements.

Financial reporting framework for small- and medium-sized entities

The AICPA has developed a financial reporting framework for Small- and Medium-Sized Entities.²⁰ The special-purpose framework is an other comprehensive basis of accounting (OCBOA) for private entities that do not need, and are not required to, issue GAAP financial statements. Other commonly used OCBOAs include cash, tax, regulatory, and contractual basis.²¹ The new framework draws upon the accrual basis of accounting but excludes certain fair value measurement and income tax accounting requirements. It also allows for accounting policy elections in more areas and has significantly fewer disclosure requirements than U.S. GAAP.

¹⁶ FASB Proposed Accounting Standards Update, Accounting for Identifiable Assets in a Business Combination, (PCC Issue No. 13-01A), available at www.fasb.org.

¹⁷ FASB Proposed Accounting Standards Update, Accounting for Goodwill, (PCC Issue No. 13-01B), available at www.fasb.org.

¹⁸ FASB Proposed Accounting Standards Update, Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements, available at www.fasb.org.

¹⁹ FASB Proposed Accounting Standards Update, Definition of a Public Business Entity, available at www.fasb.org.

²⁰ AICPA Financial Reporting Framework for Small- and Medium-Sized Entities, available at www.aicpa.org.

²¹ AU-C Section 800, Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks.



SEC's IFRS work plan

The SEC has not yet reached any conclusions on the broad incorporation of IFRS into the financial reporting system for U.S. issuers. The SEC staff issued its final IFRS work plan report in July 2012 that summarized its efforts and findings, but did not provide any conclusions or recommendations for actions by the Commission.²²

The SEC staff studied six areas identified in the work plan (including sufficient development and application of IFRS for U.S. domestic reporting and independence of the standard-setting process for the benefit of investors) that could inform the SEC's determination of whether, and if so, how and when, IFRS might be incorporated into the financial reporting system for U.S. issuers. The final report points out that additional analysis and consideration would be needed before the Commission can make any decision. The SEC staff will be developing recommendations for the Commission's consideration, separate from its work plan efforts, but the timing is unknown.

While private companies are not within the SEC's domain, the report considers the implications of IFRS incorporation because it could affect U.S. GAAP depending on how it is incorporated and because some private companies may subsequently access the U.S. public markets and become subject to SEC reporting requirements. While acknowledging that the method of incorporation could affect private companies, the SEC staff also said that the Financial Accounting Foundation may need to determine what role the PCC would have in endorsing IFRS.

²² SEC Final Staff Report, Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers, July 13, 2012, available at www.sec.gov.



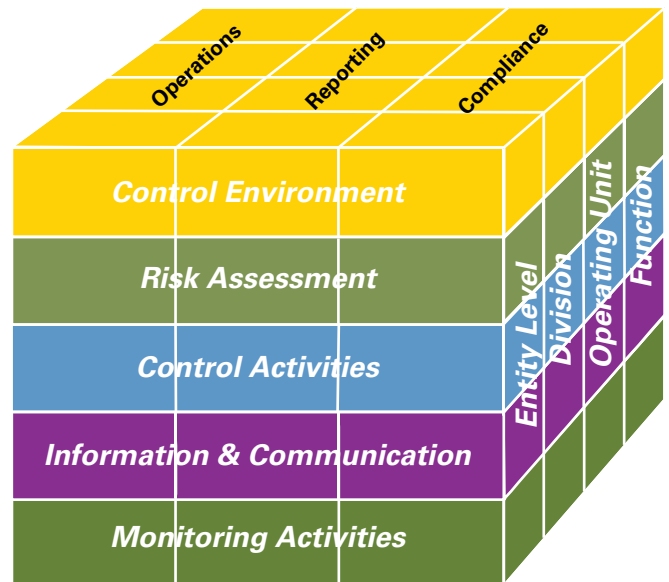
COSO's revised Internal Control Framework

Earlier this year, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released its updated Internal Control – Integrated Framework (2013 Framework).²³ While the 2013 Framework retains the core definition of internal control and its five components (Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring Activities), it is intended to clarify how to design and implement systems of internal control to adapt to changes in business and operating environments.

The most significant change made in the 2013 Framework is the codification of the 17 principles that support the five components. The 17 principles were fundamental concepts implicit in the 1992 Framework. For effective internal controls, the 2013 Framework requires that (1) each of the five components and the 17 relevant principles be *present* and *functioning* and (2) the five components must operate together in an integrated manner. The 2013 Framework also provides example characteristics for each of the 17 principles, called Points of Focus, to assist management in determining whether a principle is present and functioning.

COSO encourages transition “as soon as is feasible” but the 1992 Framework will remain available during the transition period (May 14, 2013 to December 15, 2014). COSO will consider the 1992 Framework superseded at the end of the transition period.

It is our understanding that there will be a period of time beyond December 15, 2014 where the SEC staff does not intend to question the use of the 1992 Framework by registrants. While it is uncertain whether the SEC will ultimately set a transition date, questions as to why a registrant continues to use a superseded framework become more legitimate with the passage of time. Registrants should clearly disclose which framework they are using.



²³ Internal Control – Integrated Framework (2013) was released by COSO on May 14, 2013. The 140 page Framework includes these appendices: A: Glossary; B: Roles and Responsibilities; C: Considerations for Smaller Entities; D: Methodology for Revising the Framework; E: Public Comment Letters; F: Summary of Changes to the COSO Internal Control – Integrated Framework (1992); and G: Comparison with COSO Enterprise Risk Management – Integrated Framework. For more information, see the press release and executive summary at www.coso.org.

Regulatory update

Trends in SEC staff comments

Areas of SEC staff comment on real estate companies include:

- Capitalization of personnel, leasing, tenant improvements, and other indirect costs, including the nature and magnitude of such costs and fluctuations in those costs from year to year
- Disclosure of significant development activities, including the anticipated completion date, square footage, and/or number of units
- Leasing activity, emphasizing the volume of new or renewed leases, impact of tenant improvement costs and leasing commissions, comparison of expiring rents to current market rents, comparison of new rents to prior rents, and expanded lease expiration schedules
- Impairment of long-lived assets, focusing on the methods and assumptions used and the company's analysis of specific assets not impaired (identified based on the staff's review of other disclosures and information)
- Determining whether acquisitions of real estate are business combinations or asset acquisitions
- Whether the amortization period of below market lease intangibles includes bargain renewal options.

Other ongoing SEC staff comment areas include:

- Early warning disclosure about goodwill impairment
- Proper identification and aggregation of operating segments
- Adequacy of cybersecurity disclosures
- Fair value disclosures
- Liquidity of foreign assets not available for use without material adverse tax implications
- Critical accounting policies

- Income tax valuation allowances
- Disclosure of business activities in countries on the State Department's list of state sponsors of terrorism (i.e., Cuba, Iran, Syria, and Sudan).

The SEC staff also emphasizes meaningful rather than boilerplate analysis within MD&A.

Frequent areas of SEC staff comment for smaller public companies²⁴:

- Accounting and reporting for reverse mergers
- Equity transactions
- Conversion options embedded in debt and equity structures and freestanding warrants
- Transition in and out of smaller reporting company status.

Updated guidance on applying Rule 3-14 for property acquisitions

The staff of the SEC's Division of Corporation Finance recently released an updated Financial Reporting Manual (as of March 31, 2013).²⁵ The most recent updates include revisions to the guidance on providing financial information for real estate acquisitions under Rule 3-14 and changes to determining the significance of equity method investees. The Rule 3-14 guidance includes updates to calculating significance of acquired properties, aggregation of insignificant properties, treatment of triple-net lease structures, and blind pools.

Custody rule: Privately offered securities

SEC's Division of Investment Management recently issued guidance that provides registered investment advisers an exemption from the requirement to maintain private stock certificates at a qualified custodian when certain criteria have been met:²⁶

²⁴ SEC Staff Presentation, *SEC CF Staff Review of Common Financial Reporting Issues Facing Smaller Issuers*, December 2012, available at www.sec.gov.

²⁵ SEC Division of Corporation Finance, *Financial Reporting Manual*, available at www.sec.gov.

²⁶ SEC IM Guidance Update No. 2013-04, available at www.sec.gov.

1. The client is a pooled investment vehicle that is subject to a financial statement audit in accordance with paragraph (b)(4) of the custody rule
2. The private stock certificate can only be used to effect a transfer or to otherwise facilitate a change in beneficial ownership of the security with the prior consent of the issuer or holders of the outstanding securities of the issuer
3. Ownership of the security is recorded on the books of the issuer or its transfer agent in the name of the client
4. The private stock certificate contains a legend restricting transfer
5. The private stock certificate is appropriately safeguarded by the adviser and can be replaced upon loss or destruction.

Nontraded REIT changes

The SEC's Division of Corporation Finance recently released disclosure guidance for nontraded REITs. The guidance addresses disclosure of distributions, dilution, redemptions, estimated value per share or net asset value, supplemental information, and Securities Act Industry Guide 5 disclosures.²⁷

General solicitation allowed

The SEC adopted a rule to implement the Jumpstart Our Business Startups (JOBS) Act's requirement to lift the ban on general solicitation or general advertising for certain private securities offerings.²⁸ The changes to Rule 506 allow an issuer to use general solicitation or general advertising in selling securities if the issuer takes reasonable steps to verify that all purchasers are accredited investors. Securities may also be offered under Rule 144A (including by general solicitation) to other-than-qualified institutional buyers (QIBs), if the securities are sold to only those buyers the seller reasonably believes are QIBs.

Pay ratio disclosures

The SEC recently voted to propose rules required by the Dodd-Frank Act that would require registrants to disclose the median annual total compensation of their employees and the ratio of that median to the annual total compensation of the company's chief executive officer.

The proposal would permit companies to determine the median by using a number of different methods. Employees include all full-time, part-time, seasonal, or temporary employees employed as of the last day of the company's fiscal year.

The proposed rules would not apply to emerging growth companies, smaller reporting companies, and foreign private issuers. The proposal is subject to a 60-day comment period.²⁹

²⁷ SEC Corporate Finance Disclosure Guidance: Topic No. 6, July 16, 2013, available at www.sec.gov.

²⁸ SEC Press Release No. 2013-124, July 10, 2013, available at www.sec.gov.

²⁹ SEC Release No. 33-9452 and SEC Release No. 34-70443, September 18, 2013, both available at www.sec.gov.

The proposed rules are required by the Dodd-Frank Wall Street Reform and Consumer Protection Act, which became law in July 2010.





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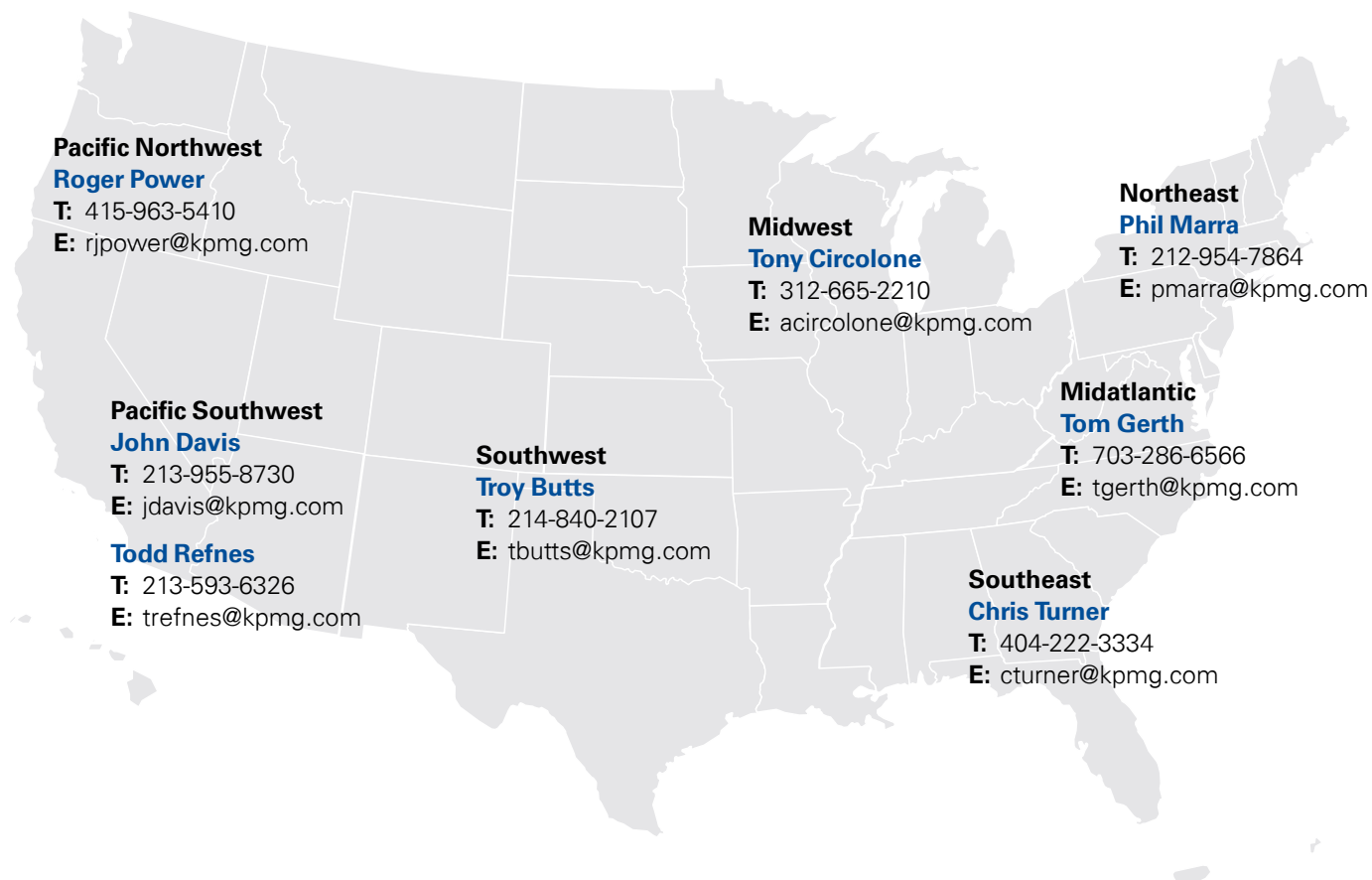
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