

AICPA Real Estate Funds Task Force
Application of AICPA Audit and Accounting Guide
Investment Companies to Real Estate Funds
12-26-07 Draft for Discussion Purposes Only

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In connection with the issuance of SOP 07-1, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*, which will require certain real estate investment vehicles that qualify as investment companies to apply the Audit and Accounting Guide *Investment Companies* (the "IC Guide"), the Accounting Standards Executive Committee of the AICPA has evaluated acceptable accounting for real estate funds applying the IC Guide. The following inquiries and replies address certain of the accounting and reporting matters that are expected to affect real estate funds in connection with their application of the IC Guide. The guidance in these inquiries and replies is considered to be an acceptable application of the IC Guide; it is not, however, intended to be prescriptive.

Transition

1. Transition of Investment Company Guide application.

Inquiry: Certain real estate entities have established significant accounting policies based on analogy to the IC Guide, based on prevalent industry accounting practices, or both. How should real estate funds that were following the IC Guide by analogy or accepted prevalent industry practice (that is, accounting practices within category (d) in the U.S. GAAP hierarchy) whereby they were applying certain, but not all, provisions of the IC Guide, including those funds that were accounting for their real estate investments through the use of consolidation or the equity method of accounting, transition to the IC Guide?

Reply: All entities are required to evaluate whether they are investment companies as defined in the IC Guide. Entities that meet the requirements to be investment companies are required to apply all of the provisions of the IC Guide in presenting their financial statements. Paragraphs 7.04 and 7.05 of the IC Guide provide that investment companies do not consolidate or apply the equity method of accounting to non-investment company investees (except for investments in operating companies that provide services to the investment company) because investment companies carry their investments at fair value. Accordingly, as further discussed below, such funds are required to recognize investment income from investees based on the dividends or distributions that are paid from economic earnings of those investees. Entities that do not meet the requirements to be an investment company should not apply the provisions of the IC Guide even by analogy.

2. Transition reporting of investment cost basis

Inquiry: The transition provisions in paragraphs 57-58 of the SOP 07-1 indicate that, if an entity had applied the IC Guide and no longer meets the provisions of the SOP to be an investment company, that entity should adopt applicable GAAP other than investment company accounting prospectively. Furthermore, those transition provisions indicate that, for entities that had not applied the IC Guide but are now investment companies within the scope of the IC Guide, the cumulative effect of adoption of investment company accounting should be reported as an adjustment to opening retained earnings as of the beginning of the year in which the SOP is adopted. Should real estate funds that had not applied the IC Guide and are now investment companies within the scope of the IC Guide conduct their reporting of initial investment cost basis amounts on a retrospective basis, on a prospective basis, or using another method?

Reply: The SOP is silent with respect to the transition reporting for investment cost basis amounts by entities that had not applied the IC Guide but are now investment companies within the scope of the IC Guide. However, as discussed in paragraph A60 of the SOP, AcSEC rejected retrospective application for entities that no longer meet the applicable investment company provisions, and concluded that the change should be accounted for prospectively, because retroactive application would require certain computations that rely on information that may be impracticable to obtain. In that regard, reporting investment cost basis amounts for entities that had not applied the IC Guide but are now investment companies within the scope of the IC Guide should be conducted on a prospective basis because another method, such as retrospective application, would require information that may be impracticable to obtain.

3. Transition accounting for investments with accumulated economic earnings.

Inquiry: How should a real estate fund that is within the scope of the IC Guide calculate economic earnings of an investment: calculated from the time the investment came into existence, or calculated from the time the real estate fund became subject to the IC Guide?

Reply: A real estate fund that is within the scope of the IC Guide should calculate economic earnings of an investment from the time the investment came into existence.

4. Transition accounting for investments that have no tax return filing requirements

Inquiry: A real estate fund applying the IC Guide upon the effective date of SOP 07-1 has interests in investment properties that since their acquisition have not been required to file tax returns. Should the real estate fund calculate economic earnings for such investments from the time the investment came into existence or from the time the real estate fund became subject to the IC Guide?

Reply: A real estate fund that is within the scope of the IC Guide should calculate economic earnings of an investment from the time the investment came into existence.

Investment income

5. Reporting of investment income

Inquiry: How should real estate funds recognize investment income from an equity ownership interest in a real estate investment under the IC Guide?

Reply: The overall objective of the IC Guide in reporting investment income from equity investments is to characterize dividends or distributions as investment income to the extent they are paid from the underlying economic earnings generated by an investment. Although economic earnings for an investment may typically be measured using U.S. GAAP applicable to the investment, the IC Guide describes as an acceptable investment income recognition principle the use of U.S. federal tax basis earnings and profits (as provided under Internal Revenue Code Section 312) in part, because the intent of Section 312 is to measure economic earnings available for distribution by an investee. Accordingly, distributions received by a fund from its equity investments are required to be recognized as investment income when such amounts are paid from economic earnings of the investment. Dividends or distributions paid in excess of economic earnings should be credited to the investment account as a return of capital.

6. Economic earnings principle

Inquiry: What are acceptable methods when measuring economic earnings of a real estate investment?

Reply: As indicated above, although economic earnings for an investment may typically be measured using U.S. GAAP applicable to the investment, the IC Guide does not prescribe specific measurement of economic earnings. For example, an investment company investing globally may be faced with practical difficulties in obtaining U.S. GAAP or U.S. tax-based information from its investees. Accordingly, the use of International Financial Reporting Standards (IFRS) may be an appropriate method of measuring economic earnings in such circumstances. An investment company's measurement of economic earnings for its investments is an accounting policy decision of the investment company. Acceptable methods include U.S. GAAP, U.S. federal tax basis earnings and profits, IFRS, as well as other comparable methods, all of which must include depreciation and amortization using reasonable estimated useful lives and exclude unrealized gains and losses resulting from fair value-based accounting measures. Because the IC Guide describes the use of U.S. federal tax basis earnings and profits as an acceptable investment income recognition principle, the

preferred approach for investment income recognition of a real estate fund is based on an investee's U.S. federal tax basis earnings and profits.

7. Consideration of depreciation and amortization expense when measuring economic earnings

Inquiry: Many participants involved in commercial real estate view depreciation and amortization expense as noncash amounts that should not be considered when measuring net investment income from real estate investments, and consider measures such as net operating income to be more meaningful when evaluating the operating performance of investment property. How does the inclusion of depreciation and amortization expense in tax basis earnings and profits of an investment meet the U.S. GAAP objective for measuring economic earnings for a real estate investment?

Reply: As illustrated in Exhibit A, the operations of investment properties often involve significant recurring and nonrecurring capital costs, including the cost of the property, building-improvement costs, leasing costs, tenant improvement costs, and other capital expenditures. Because lease related costs (such as leasing costs and tenant improvement costs) are an integral part of the economic and contractual arrangements between landlords and tenants, and because all capital costs can significantly affect the net profit generated from an investment property over its life, depreciation and amortization expense relating to such amounts is necessary in order to reflect the economic earnings of an investment property. Although other measures of operating performance such as net operating income may be meaningful and should be considered for additional disclosure, the omission of the cost of the property, building-improvement costs, leasing costs, tenant improvement costs, and other capital expenditures from earnings and profits of an investment would ignore significant costs that affect the net economic earnings generated from an investment.

8. Reporting investment income from equity investments structured as partnerships

Inquiry: Should investment income reporting be different for investments structured as partnerships (or taxed as partnerships) and investments structured in the corporate form?

Reply: No, investment income from equity investments structured as partnerships (or taxed as partnerships) should be reported in a manner that is consistent with the reporting of investment income from investments structured in the corporate form. However, certain timing differences may exist because distributions from equity investments structured in the corporate form are recorded on the ex-dividend date, while distributions from equity investments structured as partnerships are typically recorded when received.

9. Tax basis earnings and profits vs. taxable income or loss

Inquiry: The IC Guide uses the term tax basis earnings and profits as part of its guidance for determining whether distributions received should be recorded as income or return of capital. For most real estate funds, are tax basis earnings and profits usually different from or the same as taxable income or loss?

Reply: The Internal Revenue Code describes the computation of earnings and profits for corporations in Section 312. The starting point for an investment's tax basis earnings and profits is its taxable income or loss less income taxes required to be paid on that amount. That amount is required to be adjusted in accordance with Section 312 to better reflect economic income available for distribution. For example, nontaxable income is included in tax basis earnings and profits, and accelerated depreciation and amortization expense are adjusted to reflect the applicable alternative straight-line depreciation method over specified periods.

10. Tax basis earnings and profits for partnership investments

Inquiry: Given that partnerships are not subject to Section 312 of the Internal Revenue Code, are there differences in the manner in which a real estate partnership should calculate tax basis earnings and profits from the way a corporation does?

Reply: No, an investment that is established as a partnership (or taxed as a partnership) should calculate tax basis earnings and profits in a manner that is consistent with that of an investment that is established as a corporation.

11. Calculation of tax basis earnings and profits

Inquiry: In determining tax basis earnings and profits of an investment, are there required tax accounting methods that should be used, or is it acceptable for an investment to use any tax accounting policies that are allowed by U.S. federal tax law?

Reply: This inquiry raises questions as to whether the calculation of tax basis earnings and profits at the investment level should be based on a prescribed set of tax accounting policies or another specified set of U.S. federal tax law compliant policies. The IC Guide does not specify a particular set of tax law compliant policies. Accordingly, the actual tax law compliant accounting policies used in the filing of the investment's federal tax return, adjusted in accordance with the earnings and profits provisions of Section 312, should be used to calculate tax basis earnings and profits for investment income recognition purposes.

In circumstances in which tax returns are not required to be filed by an investment (for example, in certain insurance company separate account arrangements), tax law compliant accounting policies should be established for the investment and followed consistently for similar types of investments based on the tax basis earnings and profits that would be reported had the investment filed U.S. federal tax returns.

12. Current period economic earnings with accumulated losses

Inquiry: An investment of a real estate fund has accumulated economic losses since inception but due to recently improved operations has economic earnings in the current period. Should current period distributions be recognized as investment income to the extent of current period economic earnings in spite of accumulated losses at the end of the period?

Reply: Yes, current period distributions received by a real estate fund from its investments should be recorded as investment income to the extent such amounts are paid from current period economic earnings of the investment.

13. Quarterly reporting of current period economic earnings

Inquiry: For those real estate funds that provide periodic interim reporting to their investors, such as quarterly financial statements, how should economic earnings from investments be applied in the interim periods?

Reply: APB Opinion No. 28 acknowledges that inherent difficulties may exist when presenting meaningful results of operations for periods of less than a full year and indicates that each interim period should be viewed primarily as an integral part of an annual period. Further, although results for each interim period should be based on the accounting principles and practices used in the preparation of annual financial statements, certain accounting principles and practices may require modification in order for the interim results to better relate to the annual period. Accordingly, interim period economic earnings from real estate investments should be determined based upon an estimate of economic earnings for the investment for the full fiscal year or alternatively use interim results to date if it is possible to estimate such amounts.

14. Investment income from fee simple investments in properties

Inquiry: Should investment income from fee simple interests in properties be reported in a manner that is consistent with the reporting of investment income from real estate investments that are held in separate legal entities?

Reply: Yes, distributions received by a real estate fund from fee simple interests in properties should be recorded as investment income to the extent such amounts are paid from economic earnings of the investment (the fee simple property).

15. Investment income on debt investments

Inquiry: How should real estate funds report investment income from debt investments under the IC Guide?

Reply: Paragraph 2.53 of the IC Guide indicates that interest income on debt securities should be accrued daily with premiums and discounts amortized using the interest method.

16. Capital gain distributions

Inquiry: How should a real estate fund report realized gains for capital gain distributions received that result from sales of property by the investee?

Reply: Distributions should be reported as realized gains to the extent such amounts are paid from capital gains earnings. Such realized gains should be reported without regard to whether capital gains are short-term or long-term capital gains.

17. Capital loss recognition

Inquiry: A real estate fund owns 100% of an LLC that held two office properties. The LLC investment sold one of the office properties for a significant capital loss and distributed the proceeds from the sale to the real estate fund. Should the real estate fund report realized losses for distributions received that result from capital loss transactions (that is, realized losses to the extent that the amount of allocated investment cost basis to such property is in excess of the distributions received from the sale of that property)?

Reply: No, realized losses should be recognized upon the final sale or liquidation of the investment. A transaction involving the sale of a property by an investee is different from a transaction involving an investor selling a portion of its interest in the investment.

18. Operating losses and undistributed operating income recognition

Inquiry: An investment of a real estate fund incurs losses or has undistributed earnings resulting from ongoing operations of the investment property. Even though no distributions are received by the real estate fund, should losses or undistributed earnings be reported within the fund's net investment income?

Reply: No, ordinary losses and undistributed operating earnings should not be reported within investment income by a real estate fund. Investment income is not recognized based on a proportionate share of the investee's income, but rather is based on cash transactions between the fund and its investment. Any effect resulting from losses incurred by the investment property or undistributed operating earnings generated by the investment property would be reflected in unrealized gain (loss) as part of the overall valuation of the investment.

19. Funding of ongoing losses

Inquiry: A real estate fund provides additional debt or equity to an underlying investment to fund losses from ongoing operations of the investment property. How should the real estate fund report the additional cash investment?

Reply: As discussed in paragraph 2.61 of the IC Guide, the fund's additional funding of its investment should be reflected as additional investment cost.

20. Distributions in excess of investment cost

Inquiry: How should a real estate fund account for cash distributions received that are in excess of investment cost?

Reply: Generally, distributions received in excess of investment cost should be recognized as realized gains. If the fund has a commitment or other obligation to fund additional capital into the investment or a contingency exists to fund capital or to repay a portion of the distribution back to the investment, the recognition of realized gain should be limited to only those amounts for which no commitment, obligation, or contingency exists. In such situations, this could result in a negative investment cost and corresponding negative investment fair value, to be shown in the fund's financial statements.

21. Complex tax allocations within an investment

Inquiry: A real estate fund invests in a joint venture with an operating partner. The joint venture does not qualify as an investment company and has typical disproportionate sharing provisions allocable to the operating partner as part of the cash distribution provisions of the joint venture agreement. In addition, special tax allocations to the joint venture partners are required as a result of the tax implications of acquisition transactions. In such circumstances, how should the real estate fund measure economic earnings of the joint venture for purposes of the fund's investment income recognition?

Reply: As part of its investment income recognition, the real estate fund should record investment income to the extent cash distributions are received by the real estate fund (pursuant to the cash distribution waterfall provisions of the joint venture agreement) and are paid from earnings that are economically attributed to the real estate fund.

Investment accounting

22. Application of FASB Statement No. 34 to investments under construction

Inquiry: A real estate entity that is required to apply the provisions of the IC Guide invests in a property under construction and holds the property in fee simple. The real estate fund borrows money from an unrelated party to finance construction. Should the real estate fund

include interest paid or accrued on construction financing in the calculation of its investment cost?

Reply: No, construction financing and related interest expense are fund level items that are separate and distinct from the investment. In such circumstances, interest on construction financing is not a component of investment cost and should be expensed by the fund. Because the cost of a real estate fund's investment consists of amounts paid for the investment, the capitalization principles inherent in FASB Statement No. 34, *Capitalization of Interest Cost*, do not apply to a real estate fund's investment company accounting. Accordingly, the cost of a real estate fund's investment consists of amounts paid to acquire the investment without regard to capitalization of underlying interest cost.

23. Application of FASB Statement No. 58 to investments under construction

Inquiry: Should a real estate fund capitalize interest in accordance with FASB Statement No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*, when reporting the cost of investments under construction when they have a significant influence over the investments?

Reply: Pursuant to paragraphs 7.04 and 7.05 of the IC Guide, consolidation or use of the equity method by an investment company of a non-investment company investee is not appropriate. Accordingly, a real estate fund should not capitalize interest for investments under construction for purposes of reporting investment cost.

24. Application of FASB Statement No. 67 to investments under construction

Inquiry: A real estate entity that is required to apply the provisions of the IC Guide invests in a property under construction. The property is held in fee simple. Do the capitalization principles of FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, apply to the calculation of the real estate fund's investment cost in the property under construction?

Reply: No, the real estate fund's investment cost consists of amounts paid for the investment, the capitalization principles inherent in FASB Statement No. 67 do not apply to a real estate fund's investment company accounting. Accordingly, the cost of a real estate fund's investment consists of amounts paid to acquire the investment without regard to the capitalization principles in FASB Statement No. 67.

25. Applicability of the cost allocation provisions of FASB Statement No. 141

Inquiry: Should a real estate fund apply the cost allocation provisions of FASB Statement No. 141, *Business Combinations*, to the underlying assets and liabilities of an acquired investment when reporting at the investment company level?

Reply: No, real estate investment companies should not apply the cost allocation principles of FASB Statement No. 141 when reporting the cost of their investments. The cost of a real estate investment company's investments generally consists of amounts paid to acquire its investment. However, cost allocations would be required at the underlying investee level and should be made in accordance with the investment company's accounting policies for measuring economic earnings of its investees.

26. Mezzanine debt investments

Inquiry: A real estate fund provides mezzanine debt financing to a property company. Should the real estate fund evaluate whether its investment is an in-substance equity investment under the guidance for acquisition, development, or construction arrangements in the AICPA's February 10, 1986 Notice to Practitioners, "ADC Arrangements" (the "Third Notice," reprinted in AcSEC Practice Bulletin 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance*)?

Reply: Yes, real estate funds should consider the guidance in the Notice to Practitioners and, if an investment falls within the scope of the Notice to Practitioners, should account for the arrangement as either a loan or an in-substance equity investment in accordance with that guidance.

Advisor fees

27. Investment advisor fees paid directly by the investor to the advisor/sponsor

Inquiry: Are real estate funds required to report investment advisor/management fees within the fund financial statements if such amounts are paid directly by the investor to the investment advisor/sponsor.

Reply: To the extent that the management contract is between the investor and the advisor/sponsor and the investor is deemed to be the primary obligor under the contract, the real estate fund should not recognize such asset management fees as an expense in its financial statements. However, such amounts should be disclosed as related party transactions in the fund's financial statements. Further such asset management fees should be included in the calculation of the financial highlights disclosures, or alternatively presented supplementally to the financial highlights disclosures, because such asset management fees represent an economic cost to the investors in the real estate fund.

28. Recognition of unrealized incentive fee liabilities

Inquiry: Under the IC Guide, should recognition of real estate fund incentive fee liabilities be based on a hypothetical liquidation at fair value approach or an FASB Statement No. 5, *Accounting for Contingencies*, approach?

Reply: Paragraph 8.02 of the IC Guide indicates that performance fee expenses should be accrued at interim dates based on actual performance and refers to SEC Release No. 7113 of the Investment Company Act of 1940, which states that performance fees should be accrued on a daily basis. This guidance results in a requirement to recognize incentive fee expense arrangements based on a hypothetical liquidation approach at each reporting period. Accordingly, an FASB Statement No. 5 approach should not be used for incentive fee liabilities. Incentive arrangements that are established as profit allocations of the fund should be reported in the statement of changes in net assets using a hypothetical liquidation approach at the end of each reporting period.

29. Reporting incentive fee expenses in the statement of operations

Inquiry: How are incentive fees required to be presented in the statement of operations under the IC Guide: as a component of net investment income or within realized and unrealized gains (losses)?

Reply: Incentive fees structured as expenses of the fund, rather than as an allocation of fund profits, should be reported in a manner similar to other advisory fees: as fund-level expenses within net investment income at the time such amounts are incurred, based on a hypothetical liquidation approach.

Schedule of investments

30. Reporting real estate investments in the schedule of investments

Inquiry: Prior to SOP 07-1, real estate funds that used a fair value reporting model coupled with consolidation of property level investments (often referred to as a fair value consolidation reporting model) generally presented only the fair value of the property on the schedule of investments, without including property-level working capital. Does SOP 07-1 change the presentation of investments for such funds?

Reply: Yes, the schedule of investments should present the aggregate fair value of each real estate investment. The fair value of an investment should consider any working capital and other monetary net asset amounts associated with the property.

31. Presentation of consolidated interests in other investment companies in the schedule of investments

Inquiry: SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships*, paragraph 12 states that "investments in other investment companies (investees), such as investment partnerships and limited liability companies, should be considered investments in securities for the purpose of applying paragraphs 11a and 11b above." (Paragraphs 11a and 11b pertain to the categorization and disclosure of investments within the schedule of investments.) Does paragraph 12 apply in circumstances in which an investment company consolidates its interest in another investment company?

Reply: No, in circumstances of a consolidated investment company, paragraph 12 would not apply as the investments within the consolidated investment company would be reported directly on the schedule of investments.

Financial highlights

32. Reporting interest expense in the expense ratio

Inquiry: Should interest expense reported by a real estate fund be included or excluded from the calculation of the expense ratio under the IC Guide?

Reply: The IC Guide states in paragraph 7.75a that, generally, the determination of expenses for computing the expense ratio should follow the presentation of expenses in the fund's statement of operations. Accordingly, interest expense is required to be included in the expense ratio. However, inconsistencies of these ratios may occur between real estate funds based upon investment structures utilized and the fund's accounting for investment interests. Accordingly, real estate funds may wish to provide additional disclosures, which may include a supplemental expense ratio in addition to the expense ratio required by the IC Guide (which excludes interest expense associated with investments).

33. Reporting incentive fees and allocations in the expense ratio

Inquiry: Are real estate fund incentive fees and incentive allocations required to be included in the expense ratio?

Reply: As noted in paragraph of 7.75 of the IC Guide, all incentives incurred (incentive fee expenses and incentive allocation amounts) are required to be included in the disclosure of financial highlights pursuant to paragraph 13 of SOP 03-04, *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide Audits of Investment Companies and AICPA Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships*. Incentive

arrangements structured as an allocation of profits are not recorded as fund level expenses (see paragraph 22 of SOP 95-2). Rather, such amounts should be presented as a separate line item within the statement of changes in net assets (see paragraph 14 of SOP 95-2), and as a separate item within the disclosure of the expense ratio.

34. Effect on the expense ratio of unconsolidated interests in other investment companies

Inquiry: Should expenses associated with unconsolidated investment companies be included in the parent investment company's expense ratio similar to master-feeder arrangements?

Reply: The expense ratio effect depends on whether the circumstances involve a master-feeder structure or a fund-of-funds arrangement. In a fund-of-funds arrangement, income and expense ratios should be computed at the fund of funds level only, with adequate disclosure that the ratios do not reflect the proportionate share of income and expenses of the underlying investee funds. In a master-feeder structure, the feeder fund should include its proportionate share of income and expenses of the master fund when computing the income and expense ratios.

Consolidation

35. Reporting 100% owned non-investment company entities

Inquiry: A real estate fund acquires a 100% equity interest in an office property and utilizes acquisition financing as part of the purchase of the investment. The purchase transaction is structured via a 100% owned LLC that is the borrower on the debt and is owner of the fee simple interest in the property. How should the real estate fund report the real estate investment and financing if the LLC does not qualify as a subsidiary investment company under paragraph 16 of SOP 07-1?

Reply: If the LLC is determined to not qualify as a subsidiary investment company under paragraph 16 of SOP 07-1, the LLC will be prohibited from being consolidated by the real estate fund pursuant to section 7.04 of the IC Guide. The interest will be recorded at its net equity fair value by the real estate fund.

36. Reporting consolidated 100% owned investment company entities

Inquiry: A real estate fund acquires a 100% equity interest in an office property and utilizes acquisition financing as part of the purchase of the investment. The purchase transaction is structured via a 100% owned LLC that is the borrower on the debt and is owner of the fee simple interest in the property. How should the real estate fund report the real estate investment and financing if the LLC qualifies as a subsidiary investment company under paragraph 16 of SOP 07-1?

Reply: If the 100% owned LLC qualifies as a subsidiary investment company under paragraph 16 of the SOP, the interest should be evaluated for consolidation.

If the interest is consolidated, the fee simple interest owned by the LLC should be reported as a real estate investment and the debt obligation should be reported as a liability on the reporting investment company's statement of net assets. The real estate investment should be reported at fair value, and the debt should be reported in accordance with the real estate fund's established accounting policies. Income distributions received by the fund from the fee simple interest should be reported in net investment income to the extent they are paid from economic earnings of the property. Interest expense should be reported in the statement of operations separate from any investment income earned from the property investment.

37. Investment income recognition when tax law requires fund level interest capitalization

Inquiry: A real estate fund invests in a property under construction with financing for the construction activities provided at the fund level. How should the fund recognize investment income in circumstances in which tax law requires construction interest to be capitalized as part of the basis of an investment?

Reply: Because fund level debt is utilized to finance the investment, the real estate fund is required to expense interest costs associated with such financing when conducting its investment company accounting. As part of its calculation of tax basis earnings and profits for the underlying investment, the fund should eliminate interest capitalized for tax purposes and the related depreciation expense reflected as part of the investment's tax basis earnings and profits.

38. Evaluating interests in investment company vs. non-investment company investees

Inquiry: Interests held by an investment company can have different reporting implications depending on whether or not the underlying investee entity qualifies as an investment company. How should one determine whether an investment company's interest in an investee represents an interest in an investment company or a noninvestment company?

Reply: All interests held by investment companies must be evaluated to determine whether they represent interests in an underlying investment company or in an underlying noninvestment company. SOP 07-1 provides guidance for determining whether an entity is an investment company within the scope of the IC Guide and includes guidance in paragraph 16 pertaining to subsidiary investment companies.

39. Application of FIN 46(R) to interests in non-investment company investees

Inquiry: Paragraph 7.04 of the IC Guide indicates that consolidation or use of the equity method of accounting by an investment company of a non-investment company investee is not appropriate. Paragraph 12.01 indicates that, until the issuance of FIN 46(R), *Consolidation of Variable Interest Entities*, investment companies generally consolidated only controlling voting interests in other investment companies. Does FIN 46(R) apply to interests in non-investment company investees held by investment companies?

Reply: No, FSP No. FIN 46(R)-7, *Application of FASB Interpretation No. 46(R) to Investment Companies*, amended FIN 46(R) to clarify that the Interpretation does not apply to investments accounted for at fair value in accordance with the specialized accounting guidance in the IC Guide.

40. Reporting unconsolidated interests in other investment companies

Inquiry: If a real estate fund concludes that it should not consolidate an interest in another investment company that is not part of a master-feeder structure, how should it account for its interest in the investment company?

Reply: If an investment company concludes that it should not consolidate an interest in another investment company that is not part of a master-feeder structure, the fund of funds guidance in paragraph 5.50 of the IC Guide should generally be followed. Paragraph 5.50 indicates that investment income reflected on the statement of operations should represent net earnings received from investee funds. Accordingly, dividends received from investee funds should be reported as investment income to the extent such amounts are paid from economic earnings of the investee fund. In accordance with paragraph 7.04 of the IC Guide, it is not appropriate to account for the interest in the investment company in accordance with the equity method of accounting. If the interest is part of a master-feeder structure, master-feeder accounting and reporting should be followed.

41. Reporting unconsolidated interests in investment partnerships

Inquiry: Would the fund of funds reporting discussed above be different if the interest in the investee involves a partnership or a flow-through entity?

Reply: No, investment companies with interests in investment partnerships or other flow-through entities that are investment companies should follow the guidance in paragraph 5.50 of the IC Guide. Accordingly, distributions received by a real estate fund from an investee fund established as a partnership or a flow-through entity should be reported as investment income to the extent such amounts are paid from economic earnings of the investee fund.

Transaction costs

42. Fair value measures and sales transaction costs

Inquiry: When estimating the fair value of real estate investments for a real estate fund, are transaction sales costs deducted from the fair value measurement?

Reply: No, a real estate fund's investment sales costs should not be deducted from the measurement of the fair value of an investment. Paragraph 2.28 of the IC Guide indicates that the fair value reported for investments is not reduced by estimated brokerage commissions and other costs that would be incurred in selling the investments.

Real estate appraisers commonly use ten-year discounted cash flow (income) analyses to estimate the existing owner's selling price of the real estate investment assuming a sale of the investment at the balance sheet date. Such discounted cash flow analyses typically assume a sale by the buyer of the real estate investment at the end of the buyer's ten-year holding period, and include transaction costs that are assumed to be incurred (by the buyer) at the end of the ten-year period. While paragraph 2.28 indicates that the fair value reported for investments should not be reduced by transaction costs, it is important to note that a ten-year discounted cash flow analysis is prepared from the perspective of a buyer in the marketplace. It is not intended to analyze the existing owner's future cash flows and does not generally consider the existing owner's sale transaction costs. Accordingly, the objective of the discounted cash flow analysis is to estimate cash flows and costs that a buyer would earn and incur if the buyer were to evaluate the purchase price for the investment. The fair value analysis for a real estate investment would require that a buyer's costs to sell be considered in the discounted cash flow analysis when they represent amounts assumed to be incurred by a buyer when the buyer ultimately sells the investment at the end of its assumed holding period.

43. Recognition of sales transaction costs

Inquiry: What is the expense recognition event that would require real estate funds reporting under the IC Guide to recognize investment sales transaction costs and liability transfer costs?

Reply: Such costs are transaction-related period costs that should be recognized at the time they are incurred. Investment sales transaction costs and liability transfer costs would generally be recognized at the time of sale of an asset or transfer of a liability.

44. Disclosure of estimated transaction costs

Inquiry: Should funds reporting under the IC Guide disclose the costs associated with selling of investments or transfers of indebtedness?

Reply: This issue relates to the transparency of disclosures associated with investment selling costs and liability transfer costs, which may be significant for real estate funds. As noted in

paragraph 2.28 of the IC Guide, the fair value of investments should not be reduced by costs to sell investments. Such costs are transaction-related period costs that should be recognized at the time they are incurred. However, because such amounts are often significant for real estate funds, it may be prudent as recommended disclosure to report estimated transaction and transfer costs in the notes to the financial statements if such amounts are significant.

Disclosure

45. Reporting public vs. private investments

Inquiry: Should real estate funds report investments in private entities differently from investments in publicly registered entities, or should they provide additional disclosures for investments in private entities vs. public entities?

Reply: This issue relates to whether there are different accounting and reporting considerations for a real estate fund that holds public investments, private investments, or both. The IC Guide does not provide for differences in the accounting and reporting of investments based on the distinction of public or private. Accordingly, public and private investments should be reported in a consistent fashion. Real estate funds may consider whether additional disclosures are prudent for private investments as underlying investment data may not be publicly available for such investments. Further, the valuation methodology utilized by the fund for public investments and private investments may differ.

46. Reporting the components of net asset value

Inquiry: Are the components of net asset value required to be presented by real estate funds that are established as partnerships or pass-through entities under the IC Guide? If so, are such amounts disclosed on the statement of net assets or in the notes and what is required to be presented?

Reply: Paragraph 7.35 of the IC Guide states that investment partnerships and other pass-through entities typically aggregate all elements of equity into partners' capital, because their results of operations are deemed to be distributed to each partner. Accordingly, the components of net asset value are not required to be presented by real estate funds that are established as partnerships or pass-through entities. However, funds that are not established as partnerships or other pass-through entities should provide the net asset value component disclosures required by paragraph 7.34 of the IC Guide.

47. Disclosure of future minimum lease payments to be received

Inquiry: Is disclosure of future minimum lease payments to be received required for funds reporting under the IC Guide?

Reply: Properties, which represent investments of a real estate fund, are not allowed to be consolidated in an investment company's financial statements. Accordingly, there is no rental income reported in the statement of operations. As a result, future minimum lease disclosures are not applicable.

Other

48. Accounting for a borrower's deferred financing costs

Inquiry: How are deferred financing costs incurred by an investment company borrower accounted for and reported on under the IC Guide?

Reply: Deferred financing costs incurred by a borrower should be accounted for in a manner that is consistent with the real estate fund's accounting policy for loans payable. For funds whose policy it is to report loans payable in accordance with par 7.30 of the IC Guide, deferred financing costs should be carried at amortized cost with amortization calculated using the interest method and included in interest expense. The unamortized amount of deferred financing costs should be reported as an asset in the statement of net assets.

49. Applicability of discontinued operations

Inquiry: Does the discontinued operations presentation under FASB No. 144, *Accounting for the Impairment and Disposal of Long-Lived Assets*, apply to real estate funds reporting under the IC Guide?

Reply: The objective of the statement of operations for an investment company is to present the increase or decrease in the net assets resulting from the entity's investment activities by reporting investment income from interest and dividends, and realized and unrealized gains/losses on investments—in other words, to present results of investment activity. Reporting in discontinued operations the investment income of investment property that has been disposed of would be inconsistent with that objective. This conclusion is consistent with the presentation of discontinued operations under the guidance provided in the AICPA Technical Practice Aid TIS No. 6931.03 "Should the Sale of Real Estate Investments Held by Employee Benefit Plans Be Treated as Discontinued Operations?"

50. Reporting deferred taxes

Inquiry: How are deferred taxes accounted for and reported on under the IC Guide?

Reply: For investment companies organized as a corporation subject to federal income taxes or others subject to certain state and local taxes, deferred taxes should be accounted for and reported upon pursuant to Chapter 6 of the IC Guide (that is, effectively under FASB No. 109,

Accounting for Income Taxes, and FIN 48, Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109).

Generally, real estate funds are “flow-through” entities that do not pay income taxes and, accordingly, FASB Statement No. 109 would not apply. However, some investment companies (or subsidiary investment companies) may be subject to state, local, or foreign taxes on net investment income and realized gains on a recurring basis. State, local, and foreign taxes, if payable, are reported on the accrual basis, including deferred taxes on the unrealized appreciation or depreciation of investments. A valuation allowance should be established for any deferred tax asset resulting from temporary differences related to unrealized depreciation that could result in deductible amounts in future years if the probability of realization of the tax benefit does not meet the criteria under FASB 109 and FIN 48, Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109). Taxes in certain foreign jurisdictions may be based on the net investment income and realized gains of the fund within that jurisdiction.

Paragraph 6.08 of the IC Guide indicates that current income tax expense is usually presented by investment companies under the separate income categories (that is, investment income or realized and unrealized gains) to which it applies. Deferred income tax expense, if any, should be presented separately.

Exhibit A**100 Broadway Office Property
Economic Earnings Illustration
Constructed in 2001 for \$100 million, demolished in 2070**

Year	Rents	Expenses	NOI	Capital Costs	Operating Cash Flow	Net Cash Flow
2001	5.0	-3.5	1.5	-102.0	-0.5	-100.5
2002	8.3	-4.5	3.8	-2.1	1.7	1.7
2003	12.5	-5.0	7.5	-2.1	5.4	5.4
2004	12.9	-5.2	7.8	-2.2	5.5	5.5
2005	13.4	-5.4	8.0	-2.3	5.7	5.7
2006	13.9	-5.5	8.3	-2.4	5.9	5.9
2007	14.3	-5.7	8.6	-2.5	6.1	6.1
2008	14.8	-5.9	8.9	-2.5	6.4	6.4
2009	15.4	-6.1	9.2	-2.6	6.6	6.6
2010	15.9	-6.4	9.5	-2.7	6.8	6.8
2011	16.5	-6.6	9.9	-2.8	7.1	7.1
2012	17.0	-6.8	10.2	-2.9	7.3	7.3
2013	17.6	-7.1	10.6	-3.0	7.6	7.6
2014	18.2	-7.3	10.9	-3.1	7.8	7.8
2015	18.9	-7.6	11.3	-3.2	8.1	8.1
2016	19.5	-7.8	11.7	-3.4	8.4	8.4
2017	20.2	-8.1	12.1	-3.5	8.7	8.7
2018	20.9	-8.4	12.6	-3.6	9.0	9.0
2019	21.7	-8.7	13.0	-3.7	9.3	9.3
2020	22.4	-9.0	13.5	-3.8	9.6	9.6
2021	23.2	-9.3	13.9	-4.0	10.0	10.0
2022	24.0	-9.6	14.4	-4.1	10.3	10.3
2023	24.9	-9.9	14.9	-4.3	10.7	10.7
2024	25.7	-10.3	15.4	-4.4	11.0	11.0
2025	26.6	-10.7	16.0	-4.6	11.4	11.4
2026	27.6	-11.0	16.5	-4.7	11.8	11.8
2027	28.5	-11.4	17.1	-4.9	12.2	12.2
2028	29.5	-11.8	17.7	-5.1	12.7	12.7
2029	30.6	-12.2	18.3	-5.2	13.1	13.1
2030	31.6	-12.7	19.0	-5.4	13.6	13.6
2031	32.8	-13.1	19.7	-5.6	14.0	14.0
2032	33.9	-13.6	20.3	-5.8	14.5	14.5
2033	35.1	-14.0	21.1	-6.0	15.0	15.0
2034	36.3	-14.5	21.8	-6.2	15.6	15.6
2035	37.6	-15.0	22.6	-6.4	16.1	16.1
2036	38.9	-15.6	23.3	-6.7	16.7	16.7
2037	40.3	-16.1	24.2	-6.9	17.3	17.3
2038	41.7	-16.7	25.0	-7.1	17.9	17.9
2039	43.1	-17.3	25.9	-7.4	18.5	18.5
2040	44.6	-17.9	26.8	-7.7	19.1	19.1
2041	46.2	-18.5	27.7	-8.1	19.6	19.6
2042	47.8	-19.1	28.7	-8.4	20.3	20.3
2043	49.5	-19.8	29.7	-8.8	20.9	20.9
2044	51.2	-20.5	30.7	-9.2	21.5	21.5
2045	53.0	-21.2	31.8	-9.6	22.2	22.2
2046	54.9	-21.9	32.9	-10.1	22.9	22.9
2047	56.8	-22.7	34.1	-10.5	23.6	23.6
2048	58.8	-23.5	35.3	-11.0	24.3	24.3
2049	60.8	-24.3	36.5	-11.5	25.0	25.0

2050	62.4	-25.2	37.2	-12.0	25.2	25.2
2051	63.9	-26.1	37.8	-12.5	25.3	25.3
2052	65.5	-27.0	38.5	-13.1	25.4	25.4
2053	67.2	-27.9	39.2	-13.7	25.5	25.5
2054	68.8	-28.9	39.9	-14.3	25.6	25.6
2055	70.6	-29.9	40.6	-14.9	25.7	25.7
2056	72.3	-31.0	41.4	-15.6	25.7	25.7
2057	74.1	-32.0	42.1	-16.3	25.8	25.8
2058	76.0	-33.2	42.8	-17.1	25.8	25.8
2059	77.9	-34.3	43.5	-17.8	25.7	25.7
2060	77.3	-35.5	41.8	-18.6	23.1	23.1
2061	72.0	-36.8	35.2	-19.5	15.8	15.8
2062	64.5	-32.1	32.4	-20.3	12.1	12.1
2063	58.0	-30.2	27.8	-16.8	11.0	11.0
2064	46.0	-24.2	21.8	-13.9	7.9	7.9
2065	36.0	-22.9	13.1	-7.5	5.6	5.6
2066	27.3	-19.5	7.8	-5.3	2.5	2.5
2067	18.3	-14.9	3.4	-3.8	-0.4	-0.4
2068	18.9	-15.4	3.5	-3.4	0.1	0.1
2069	19.6	-16.0	3.6	-2.3	1.3	1.3
2070	15.4	-14.2	1.2	-2.4	-1.2	-1.2
	2,607.1	-1,141.9	1,465.2	-617.6	947.6	847.6

Economic Earnings Principle:

Rents	2,607.1
Expenses	-1,141.9
NOI	1,465.2
Recurring Capital Costs	-517.6
Operating CF	947.6
Construct Costs	-100.0

Net Cash Flow 847.6

Investment income to be reported over the life of this real estate investment is \$847.6, which represents the net economic earnings of the investment. Net economic earnings are reflected through annual depreciation & amortization of capital costs.