

Chapter 2 - Market Value Accounting and Reporting Standards

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Chapter 2 - Market Value Accounting and Reporting Standards

Introduction

.01 The development of the Market Value Accounting and Reporting Standards resulted primarily from the realization that standardization of meaningful financial reporting was necessary in order to allow real estate to become more acceptable as an institutional investment asset class. Accounting standards promulgated by authoritative accounting bodies exist for various real estate entities, including public real estate investment trusts and other public and private real estate entities that utilize historical cost accounting. The reporting requirements and information expectations of the institutional real estate investment community required the development of a market value-based financial reporting model for which no accounting standards published by authoritative accounting bodies presently exist. Accordingly, the lack of adequate authoritative guidance applicable to market value accounting for institutional real estate investment vehicles necessitated the need for these standards to be published. The **NCREIF REIS** *Market Value Accounting Policy Manual*, which can be found in Appendix 1, is an integral part of REIS.

Required and Recommended Practices

.02 *Required practices: ~~of the Market Value Accounting and Reporting Standards include:~~*

1. The books and records are to be maintained~~Maintenance of books and records~~ on the market value basis of accounting in conformity with the **NCREIF REIS** *Market Value Accounting Policy Manual*.
2. Annual financial statement reporting.
3. Quarterly ~~financial statement~~ reporting of financial statement information.

~~Recommended Practices~~

.03 *Recommended practices ~~include:~~*

1. Annual financial statement audits conducted in accordance with auditing standards generally accepted in the United States of America.

Authority within GAAP

.04 The fundamental premise for the market value-based accounting model is based on existing authoritative accounting standards, which require that certain investments held by tax-exempt investors,

including defined benefit pension plans and endowments, be reported at fair value. For example, Financial Accounting Standard No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, which applies to corporate plans, requires that all plan investments be reported at fair value because that reporting provides the most relevant information about the resources of a plan and its present and future ability to pay benefits when due. In addition, Government Accounting Standard No. 25 requires government sponsored pension plans to present investments at fair value in their financial statements. As a result, the more traditional historical cost basis of accounting used by other real estate companies, owners and operators is not appropriate, as it does not provide tax-exempt investors with the financial information they require to comply with authoritative accounting standards.

.05 Institutional real estate investment vehicles include open and closed-end commingled funds, pooled trusts and separate accounts, many of which have attributes similar to those of an “investment company”, as set forth in the AICPA Audit and Accounting Guide – *Audits of Investment Companies* (the “**Investment Company** Guide”). The accounting profession has used this authoritative guidance to support the use of a value-based accounting model for investment companies. At present, the applicability of the Guide to various types of investment vehicles is unclear. Additional authoritative guidance is currently planned **for 2006**, which is expected to help clarify the intended scope of the **Investment Company** Guide. ~~The institutional real estate investment industry has adopted accounting practices, which, while conceptually similar, may differ from those described in the Guide, primarily on the basis that the Guide does not adequately address the accounting and reporting issues that exist for institutional real estate investment vehicles. Notwithstanding vehicles. Notwithstanding the clarification of the scope, the Investment Company Guide does not adequately address the accounting and reporting issues that exist for institutional real estate investment vehicles. The institutional real estate investment industry uses has adopted accounting practices, which while conceptually similar, may differ from those currently described in the Investment Company Guide. The AICPA has formed an additional task force to explore the accounting and reporting needs of real estate investment vehicles.~~

Position within the GAAP Hierarchy

.06 Accounting rules state that in the absence of authoritative guidance, prevalent accounting practices in an industry form the basis for generally accepted accounting principles (GAAP) in that industry. The lack of applicable authoritative accounting guidance has caused predominant market value accounting practices to constitute GAAP in the institutional real estate investment industry. Market Value Accounting and Reporting Standards ~~themselves have no written authority within the GAAP hierarchy. Only to the extent that such standards represent prevalent accounting practices currently used in the industry, and to the extent that no authoritative accounting guidance applies, are such standards recognized in the GAAP hierarchy. Many accounting and reporting practices used in market value reporting are consistent~~ The accounting and reporting practices used in market value reporting begin with historical cost accounting principles. The focus of the Market Value Accounting and Reporting Standards is on differences from historical cost reporting covered by authoritative accounting guidance. In certain instances the accounting for a particular item is described, even though it is consistent with historical cost reporting, to underscore the consistency when a difference may be perceived. Such specific guidance is provided within the ~~separate~~ **NCREIF REIS** *Market Value Accounting Policy Manual*.

For specific reporting issues encountered by an individual investment vehicle, the applicable technical literature should be consulted to provide the most recent guidance for the appropriate accounting and disclosure in the financial statements.

Conceptual Framework

.07 As indicated above, the basis for the market value financial reporting model was rooted in the requirement that institutional investors report their investments at fair value in accordance with authoritative accounting standards. The fair value of an asset represents the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced liquidation or sale. Accordingly, a primary condition of market value accounting is that asset and liability-carrying amounts, including unrealized gains and losses, would be realized by investors in an assumed transaction at the balance sheet date. ~~In essence, the conceptual framework for a market value balance sheet is generally consistent with a break-up approach based on a hypothetical liquidation of assets and liabilities at fair value.~~ The term *market value* is the equivalent of *fair value* as defined by the Financial Accounting Standards Board. Within the **NCREIF REIS** Market Value Accounting and Reporting Standards these terms are used interchangeably.

In June 2004, the Financial Accounting Standards Board issued an Exposure Draft, which among other things, would revise the definition of fair value to be "...the price at which an asset or liability could be sold or exchanged in a current transaction between knowledgeable, unrelated willing parties". Since that time, the Financial Accounting Standards Board has continued deliberations and considered changes to this definition. If adopted as proposed, the statement would be effective for fiscal years beginning June 15, 2005—the recognition and measurement requirements of the statement would be effective for fiscal years beginning after December 15, 2006 (with disclosure requirements effective for fiscal years ending after December 15, 2006).

Net Asset Value

.08 All assets and liabilities are reported at market value, which is generally the amount at which the asset (or liability) could be sold (or settled) in a current transaction between willing parties. ~~In certain cases, notes payable are reported at their expected present value. Additional guidance regarding notes payable can be located within the separate NCREIF Debt Accounting Workbook.~~

Net Investment Income

.09 Net investment income is the measure of operating results under the market value financial reporting model. It is primarily intended to provide a measure of operating cash flow over time, exclusive of capitalized expenditures such as leasing commissions, tenant improvement costs and other replacement costs. Rental revenue is recognized when it is contractually billable to tenants. Expenses are generally recognized when the obligation is incurred, ~~under the requirements of Financial Accounting Standard No. 5.~~ **Certain** expenses which may be based on the investment vehicle's unrealized change in net asset value, such as incentive management fees, are recognized currently as a component of the unrealized gain or loss, even if their future payment is contingent.

Differences from Other Bases of GAAP Reporting

.10 Many of the accounting and reporting practices described in the Market Value Accounting and Reporting

Standards are consistent with generally accepted accounting principles used in the historical cost reporting environment. The Market Value Accounting and Reporting Standards are intended to support the information expectations of the institutional real estate investment community, which requires a market value-based financial reporting model. The market value basis of accounting in conformity with accounting principles generally accepted in the United States of America is intended to provide for the valuation and reporting of assets and liabilities, and the related measurement of investment operating results. Net investment income is not intended to approximate net income determined under the historical cost of accounting model. Among other differences, net investment income under the market value financial reporting model does not generally include the effect of rent normalization under FASTB 85-3, *Accounting for Operating Leases with Scheduled Rent Increases*, cost-based depreciation or amortization of most capitalized expenditures, or impairment accounting provisions. These effects are accounted for as part of the periodic valuation of assets and liabilities and, accordingly, are reported as part of the change in unrealized gain or loss.

~~Investment Vehicles—Special Considerations~~

~~11 Certain investors in real estate investment vehicles do not anticipate realizing their investment value through sales of the underlying net assets of the investment vehicle but expect to sell their interests in the investment entity. This may typically be the case in an open-end fund. Industry participants note that in certain circumstances, such as an example involving nontransferable favorable rate financing in an open-end fund, a conceptual balance sheet framework based on a break-up approach may not meet the valuation and reporting needs of the open-end fund investor. The Market Value Accounting and Reporting Standards recognize that in certain limited instances, relevant facts and circumstances need to be considered in order to adequately meet the reporting needs of those who invest in different investment vehicles. However, factors such as product and geographic diversification in a real estate portfolio, and management expertise, are not explicitly considered in the accounting or valuation requirements of an investment vehicle.~~

IV. APPENDIX

Real Estate Information Standards

~~National Council of Real Estate Investment Fiduciaries~~ Market Value

Accounting Policy Manual

February 20035

Real Estate Information Standards Market Value Accounting Policy Manual

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Real Estate Information Standards Market Value Accounting Policy Manual

1. Market Value Accounting and Reporting Standards

Introduction

1.01 The development of the Market Value Accounting and Reporting Standards resulted primarily from the realization that standardization of meaningful financial reporting was necessary in order to allow real estate to become more acceptable as an institutional investment asset class. Accounting standards promulgated by authoritative accounting bodies exist for various real estate entities, including public real estate investment trusts and other public and private real estate entities that utilize historical cost accounting. The reporting requirements and information expectations of the institutional real estate investment community required the development of a market value-based financial reporting model for which no accounting standards published by authoritative accounting bodies presently exist. Accordingly, the lack of adequate authoritative guidance applicable to market value accounting for institutional real estate investment vehicles created the need for these standards. The **NCREIF-REIS** Market Value Accounting Policy Manual (the “Manual”) represents an integral part of the Real Estate Information Standards.

Certain terms as used herein are defined as follows:

- Financial Accounting Standards Board: FASB
- Statement of Financial Accounting Standards: SFAS
- Government Accounting Standards Board: GASB
- American Institute of Certified Public Accountants: AICPA
- US generally accepted accounting principals: GAAP

Required Practices

1.02 Required practices of the Market Value Accounting Standards include:

- Maintenance of books and records on the market value basis of accounting in conformity with the **NCREIF-REIS** Market Value Accounting Policy Manual.
- Annual financial statement reporting.
- Quarterly ~~financial statement reporting~~ reporting of financial statement information.

Recommended Practices

1.03 Recommended practices include:

- Annual financial statement audits conducted in accordance with auditing standards generally accepted in the United States of America.

Authority within GAAP

1.04 The fundamental premise for the market value-based accounting model is based on existing authoritative accounting standards, which require that certain investments held by tax-exempt investors, including defined benefit pension plans and endowments, be reported at fair value. For example, Financial Accounting Standard No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, which applies to corporate plans, requires that all plan investments be reported at fair value because that reporting provides the most relevant information about the resources of a plan and its present and future ability to pay benefits when due. In addition, ~~Government Accounting GASB~~ Standard No. 25 requires government sponsored pension plans to present investments at fair value in their financial statements. As a result, the more traditional historical cost basis of accounting used by other real estate companies, owners and operators is not appropriate, as it does not provide tax-exempt investors with the financial information they require to comply with authoritative accounting standards.

1.05 Institutional real estate investment vehicles include open and closed-end commingled funds, pooled trusts and insurance company separate accounts, many of which have attributes similar to those of an “investment company”, as set forth in the AICPA Audit and Accounting Guide – *Audits of Investment Companies* (the “Investment Company Guide”). The accounting profession has used this authoritative guidance to support the use of a value-based accounting model for investment companies. At present, the applicability of the Investment Company Guide to various types of investment vehicles is unclear. Additional authoritative guidance is ~~currently planned which is expected in 20056, which will to~~ help clarify the intended scope of the Investment Company Guide. ~~Notwithstanding the clarification of the scope, the Investment Company Guide does not adequately address the accounting and reporting issues that exist for institutional real estate investment vehicles.~~ The institutional real estate investment industry has adopted uses accounting practices, which, while conceptually similar, may differ from those described in the Investment Company Guide, ~~primarily on the basis that the Guide does not adequately address the accounting and reporting issues that exist for institutional real estate investment vehicles.~~ The AICPA has formed an additional task force to explore the accounting and reporting needs of real estate investment vehicles.

Position within the GAAP Hierarchy

1.06 Accounting rules state that in the absence of authoritative guidance, prevalent accounting practices in an industry form the basis for generally accepted accounting principles (GAAP) in that industry. The lack of applicable authoritative accounting guidance has caused predominant market value accounting practices to constitute GAAP in the institutional real estate investment industry. Market Value Accounting and Reporting Standards themselves have no written authority within the GAAP hierarchy. Only to the extent that such standards represent prevalent accounting practices currently used in the industry, and to the extent that no authoritative accounting guidance applies, are such standards recognized in the GAAP hierarchy. ~~Many of the~~ The accounting and reporting practices used in market value reporting are consistent begin with historical cost accounting principles. The focus of the Market Value Accounting and Reporting Standards is on differences from historical cost reporting covered by authoritative accounting guidance. In certain instances the accounting for a particular item is described, even though it is consistent with historical cost reporting, to underscore the consistency when a difference may be perceived.

For specific reporting issues encountered by an individual investment vehicle, the applicable technical accounting literature should be consulted to provide the most recent guidance for the appropriate accounting and disclosure in the financial statements.

Conceptual Framework

1.07 As indicated above, the basis for the market value financial reporting model was rooted in the requirement that institutional investors carry their investments at fair value in accordance with authoritative accounting standards. The fair value of an asset represents the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Accordingly, a primary condition of market value accounting is that asset and liability carrying amounts, including unrealized gains and losses, would be realized by investors in an assumed transaction at the balance sheet date. ~~In essence, the conceptual framework for a market value balance sheet is generally consistent with a break up approach based on a hypothetical liquidation of assets and liabilities at fair value.~~ The term *market value* is the equivalent of *fair value* as defined ~~in SFAS No. 107 by the Financial Accounting Standards Board.~~ Within the Market Value Accounting and Reporting Information Standards these terms are used interchangeably.

~~In June 2004, the FASB issued an Exposure Draft, which, among other things, would revise the definition of fair value to be "...the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties." Since that time, the FASB has continued its deliberations and considered changes to this definition. If adopted as proposed, the recognition and measurement requirements of the sStatement would be effective for fiscal years beginning after December 15, 2006 (with disclosure requirements effective for fiscal years ending after December 15, 2006). June 15, 2005.~~

Net Asset Value

1.08 All assets and liabilities are reported at market value, which is generally the amount at which the asset (or liability) could be sold (or settled) in a current transaction between willing parties. ~~In certain cases notes payable are reported at their expected present value. Additional guidance regarding notes payable can be located at both Section 3.01 and within the separate NCREIF Debt Accounting Workbook.~~

Net Investment Income

1.09 Net investment income is the measure of operating results under the market value financial reporting model. It is primarily intended to provide a measure of operating cash flow over time, exclusive of capitalized expenditures such as leasing commissions, tenant improvement costs and other replacement costs. Rental revenue is recognized when it is contractually billable to tenants. Expenses are generally recognized when the obligation is incurred, ~~under the requirements of Financial Accounting Standard No. 5.~~ ~~Certain expenses which may be based on the investment vehicle's unrealized change in net asset value, including for example incentive management fees, are recognized currently as a component of the unrealized gain or loss, even if their future payment is contingent.~~

Differences from Other Bases of GAAP Reporting

1.10 Many of the accounting and reporting practices described in the Market Value Accounting and Reporting Standards are consistent with generally accepted accounting principles used in the historical cost

reporting environment. The Market Value Accounting and Reporting Standards are intended to support the information expectations of the institutional real estate investment community, which requires a market value-based financial reporting model. The market value basis of accounting in conformity with accounting principles generally accepted in the United States of America is intended to provide for the valuation and reporting of assets and liabilities, and the related measurement of investment operating results, as ~~discussed~~summarized above. Net investment income is not intended to approximate net income determined under the historical cost of accounting model. Among other differences, net investment income under the market value financial reporting model does not generally include the effect of rent normalization under FASB Technical Bulletin No. 85-3 *Accounting for Operating Leases with Scheduled Rent Increases*, cost-based depreciation or amortization of most capitalized expenditures, or impairment accounting provisions. These effects are accounted for as part of the periodic valuation of assets and liabilities and, accordingly, are reported as part of the change in unrealized gain or loss.

~~Investment Vehicles—Special Considerations~~

~~1.11 Certain investors in real estate investment vehicles do not anticipate realizing their investment value through sales of the underlying net assets of the investment vehicle but expect to sell their interests in the investment entity. This may typically be the case in an open-end fund. Industry participants note that in certain circumstances, such as an example involving nontransferable favorable rate financing in an open-end fund for example, a conceptual balance sheet framework based on a break-up approach may not meet the valuation and reporting needs of the open-end fund investor. The Market Value Accounting and Reporting Standards recognize that in certain limited instances, relevant facts and circumstances need to be considered in order~~

~~to adequately meet the reporting needs of different investment vehicles. However, factors such as product and geographic diversification in a real estate portfolio, and management expertise, are not explicitly considered in the accounting or valuation requirements of an investment vehicle.~~

2 Real Estate Investments

2. Real Estate Investments

2.01 Under the market value basis of accounting, real estate investments are carried on the balance sheet at their market value. Changes in market value from period to period are recognized as unrealized gains or losses until sale or disposition of the interest in the underlying real estate investment.

2.02 Real estate investments generally include one of the following three forms:

- *Controlling Equity Interests* – Either the direct 100% ownership of real estate assets or the ownership of a controlling equity interest in another entity which owns real estate assets. Within this Manual, these investments are referred to as investments in real estate assets.

- *Non-Controlling Equity Interests* – The ownership of a non-controlling equity interest in another entity which owns real estate assets. Within this Manual, these investments are referred to as investments in joint ventures.
- *Debt Interests* – The ownership of a mortgage loan or other note receivable secured by real estate assets owned by another party. These notes can be either participating or non-participating. Participating notes generally entitle the holder to contingent payments based on a property's operating results and/or a portion of the profit from an asset's sale in addition to payments of contractual principal and interest. Nonparticipating notes generally entitle a holder to payments of contractual principal and interest that do not increase based on the underlying operating results of a property. Within this Manual, these investments are referred to as investments in mortgage loans.

2.03 Regardless of the form of investment held, the underlying real estate assets include all investments in land, buildings, construction in progress, tenant improvements, tenant allowances, furniture, fixtures and equipment, leasing commissions, capitalized leasehold interests, capitalized interest, capitalized real estate taxes, and real estate to be disposed ~~of~~.

Investments in Real Estate Assets

2.04 Real estate investments include investments in real estate assets by an investor, as well as holdings of controlling equity interests in separate legal entities, which invest in real estate assets. GAAP in a historical cost reporting environment generally requires an investor to initially determine whether the investee is a variable interest entity under FASB Interpretation No. 46R ("FIN 46R"). However, there are several investment vehicles that are not within the scope of FIN 46R, including registered investment companies, separate accounts of life insurance companies and employee benefit plans. In addition, the FASB has deferred the effective date of applying FIN 46R to non-registered investment companies until the AICPA finalizes its proposed Statement of Position relating to the scope of the Investment Company Guide as indicated in Section 1.05 above. As a result, it is believed that real estate investment vehicles reporting on a market value basis are not subject to FIN 46R, but rather will determine whether or not to consolidate an investee based on the determination of control, and follow relevant authoritative accounting literature (such as ARB No. 51 or AICPA Statement of Position 78-9).

~~The NCREIF Accounting Standards REIS requires~~ that the financial statements of controlled investees be consolidated with those of the investor. Existing consolidation guidance provided within authoritative accounting literature governs when an interest in a separate entity is considered to be controlling. While in general the ownership of a greater than 50% voting interest in an entity is considered to be an indication of control, many joint venture real estate investments contain complex governance arrangements that make assessments of control difficult. ~~In addition, new accounting guidance provided by FASB Interpretation No. 46 may need to be considered when evaluating joint venture arrangements.~~ All factors must be considered in making a determination of whether consolidation of an investee is appropriate. For investments in entities that are not deemed to be controlling interests, the equity method of accounting should generally be followed.

2.05 Real estate assets either owned directly by an entity or reported through the consolidation of an investee are recorded on the balance sheet at their market value. If the investee is less than 100% owned, a corresponding credit to minority interest is recorded at market value for the noncontrolling interest in the investment. The difference between market value and the adjusted cost basis of an investment is the

unrealized gain or loss associated with the asset, and if applicable, the noncontrolling interest. Changes in market value from period to period are reported as changes in unrealized gain or loss on the income statement which is presented separately from net investment income. These gains or losses are realized upon the disposal of an investment, however, in order to record a realized gain, the sale is required to meet the criteria of SFAS No.66. Gains, which are deferred in accordance with SFAS No. 66, Accounting for Sales of Real Estate, continue to be reported as unrealized.

Determination of the Cost Basis of Real Estate Assets

2.06 The initial cost basis of a real estate asset includes all direct costs of acquiring the real estate asset. This includes acquisition fees paid to investment advisors associated with the closing of a new investment. For development properties, the cost basis of these assets should also include costs capitalized during the development period including interest, insurance and real estate taxes. Authoritative accounting literature, including SFAS 34, Capitalization of Interest Cost, and SFAS 67, Accounting for Costs and Initial Rental Operations of Real Estate provides guidance relating to the appropriate cost capitalization criteria. Since real estate investments are recorded at market value each reporting period, none of the components (building, equipment, improvements, lease costs, in-place lease value, lease origination costs, etc.) are depreciated or amortized.

2.07 The initial cost basis of a real estate asset should be subsequently adjusted for additional capital costs such as tenant improvements, tenant allowances, tenant leasing commissions and tenant buyouts. These capital items are generally made to maximize cash flows and generate additional income, which, in turn, influence the market value of the real estate asset. Because the nature of these costs is such that they have benefits that extend beyond one year, the addition of these items to an asset's carrying value is considered appropriate.

2.08 This treatment extends to all generations of tenant related capital costs, even after the tenants to whom they relate have vacated a property. These types of property-related costs represent additional investments in the property which should be considered in any examination of the current market value of the asset against an investor's investment in it. In addition, this methodology requires the weighing of the cost of obtaining a new tenant against the expected change in the property's value.

2.09 Capitalized costs associated with a real estate asset ~~shouldare not-be~~ amortized, as amortizing would ~~just be offset by anereate a false increase- an increase~~ in unrealized appreciation in the same or subsequent periods. ~~due to an accounting convention. In addition, such costs are not amortized under the theory that the relative success of the investment manager will be assessed when the property is sold or appraised, and gains or losses are calculated as the difference between all the costs associated with the asset and the value of the asset, using an actual sales price or the appraised value.~~

2.10 [Reserved for future use] ~~A determination must be made during the interim periods between market value updates as to the treatment of capital improvements to the property. If the portfolio's policy is to record appreciation between valuation dates, an assessment must then be made as to whether an increase in a particular capitalized cost has a dollar for dollar increase in the market value of that property. If, under whatever methodology a portfolio employs, additional costs capitalized to an investment's basis between valuation updates do not result in incremental value to the property, a change in unrealized loss should be~~

~~recorded during those periods.]~~

Determination of Real Estate Market Value

~~2.11 The term market value as used in the NCREIF-REIS Accounting Standards is the equivalent of fair value as defined by authoritative accounting literature. It represents the amount at which the asset could be bought or sold in a current transaction between willing parties, i.e., other than in a forced or liquidation sale. The market value of real estate assets is generally estimated using any one or a combination of accepted appraisal methodologies utilized by independent appraisers within the real estate industry. The most prevalent valuation method utilized by real estate investors is the income approach. However, to obtain sufficient evidence to support a determination of market value, it may be necessary to use several appraisal techniques, including the comparable sales and cost method, and reconcile their differences.~~

2.12 The market value of property that is expected to be held for investment should generally be valued in a manner consistent with the REIS Property Valuation Standards. The income approach is generally calculated by capitalizing a stabilized net operating income or by discounting future cash flows. The discounted cash flow method of appraisal estimates future cash inflows and outflows, which include a residual sale cash flow generally at the end of an assumed holding period, usually ten years. Such amounts are discounted at an appropriate rate of return that a prudent buyer would currently require to purchase the real estate asset. (Please see the REIS Property Valuation Standards for more information.)

~~2.13 Market value generally should be based on current development rights and entitlements, and assumptions about development or changes in market entitlements if those assumptions are based on reasonably objective factors and would be included in the determination of value in a competitive and open market. For those investments in real estate which are considered “assets to be disposed of” in accordance with SFAS No. 144, their carrying value should be market value reduced by estimated cost to sell. Disposition fees should be considered when determining estimated costs to sell. This accounting treatment is consistent with SFAS No. 144, which requires that assets to be disposed of be reported at “the lower of carrying value or fair value less cost to sell.”~~

~~2.14 The market value of property that is expected to be held for long-term investment should generally be valued in a manner consistent with the REIS Property Valuation Standards. The market value of a real estate asset should not include any effects of a related above or below market mortgage debt except when debt is assumed on acquisition. Upon assumption of debt the impact of above/below market value debt is assigned to the cost basis of the real estate asset. The real estate and the related mortgage are to be valued separately and are to be shown separately on the Statement of Assets and Liabilities.~~

~~2.15 SFAS No., 144 also requires that the cost basis of “impaired” assets be written down to fair value. Under REIS, the impairment accounting guidance provided by SFAS 144 is not applicable to the cost basis of real estate assets in a market value basis presentation.~~

~~For those investments in real estate which are considered “assets to be disposed of” in accordance with SFAS No. 144, their carrying value should be market value reduced by estimated cost to sell. Disposition fees should be considered when determining estimated costs to sell. This accounting treatment is consistent with SFAS No. 144, which requires that assets to be disposed of be reported at “the lower of carrying value or fair value less cost to sell.”~~

~~2.16 The market value of a real estate asset should not include any effects of a related above or below market mortgage debt. The real estate and the related mortgage are to be valued separately and are to be shown separately on the Statement of Assets and Liabilities. For market value accounting, prior to the issuance of SFAS No. 144, it was common practice to carry investments in real estate at the higher of the market value of the real estate or the non-recourse debt amount. SFAS No. 144 addresses this practice and specifically disallows it. Investments in real estate should be carried at market value, irrespective of related financing.~~

~~2.17 SFAS No. 144 also requires that the cost basis of "impaired" assets be written down to fair value. NCREIF believes that the impairment accounting guidance provided by SFAS 144 is not applicable to the cost basis of real estate assets in a market value basis presentation.~~

~~Operating Revenues and Expenses~~

~~2.16 During the ownership of and investment in real estate assets, real estate revenues directly associated with the underlying property or properties may include the following: revenues and operating expenses. Examples of operating revenues include rental income as well as funds receivable for the recovery of real estate expenses, percentage rent and miscellaneous tenant charges. Real estate expenses may Examples of operating expenses include utility costs, property management fees, real estate taxes, and normal maintenance expenses.~~

~~2.17 Operating Real estate revenue should be recorded when it is contractually earned and billable. Rent concessions (such as free rent, stepped rent) should not be recorded as income until the rent payments are earned and billable as the appraisal process factors in the future rental income in the determination of the property's value. For the same reasons, an above or below market component of a lease contract in place at the date of acquisition, if allocated pursuant to SFAS No. 141, should not be amortized against or accreted into rental income. Accruing for free rent/stepped rent would in essence be accounting for the same item twice (i.e., once in the property's valuation and again in an accounts receivable/other asset account outside the property base).~~

~~2.20 18 Penalties or other lump sum payments received or receivable from tenants who choose to terminate their lease prior to the end of the lease term should be recorded as income when the following criteria have been met: the tenant loses his right to use the space; the owner has no further obligation to provide services; and when payment is determined to be probable.~~

~~2.21 19 Operating Real estate expenses should be accrued recognized when incurred. Where property operating expenses are paid directly by tenants (i.e., net leases), rather than reimbursed to the landlord, the operating revenues and expenses of the related property generally should not be grossed up for the payments made by the tenant for the expenses, and the expenses themselves. Rather, such expenses and tenant payments should generally be reported as net amounts on the income statement. Companies should consider authoritative accounting literature such as EITF Issue No. 9919, Reporting Revenue Gross as a Principal versus Net as an Agent, for recording of revenues and expenses gross or net.~~

~~2.20 SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets, addresses the financial accounting and reporting for the impairment of long-lived assets and for long-lived assets to be disposed. Among other things, SFAS 144 does not apply to intangible assets not being amortized or financial instruments, including investment in equity securities accounted for under the cost or equity method.~~

Although SFAS 144 is silent with respect to investments accounted for at market value under either SFAS 35, GASB 25, separate accounts under SFAS 60, or in accordance with the Investment Company Guide, SFAS 144 does not amend any of the guidance provided in these references.

2.21 The objective of the statement of operations is to present the increase or decrease in the net assets resulting from the entity's investment activities by reporting investment income from interest, dividends, income from the ownership of real estate, and realized and unrealized gains/losses on investments. That format helps the user understand the contributions or each aspect of the investment activity to the company's overall results. As the objective of the statement of operations is to present results of investment activity, reporting in discontinued operations the results of operations of a real estate investment that has been disposed would be inconsistent with that objective. Therefore, the discontinued operations presentation of SFAS 144 is not applicable to real estate investment vehicles reporting at market value.

Investments in Mortgages and Other Loans

2.22 There are primarily two types of mortgage loan investments held by institutional real estate investors, non-participating and participating mortgage loans. A non-participating mortgage loan is an investment secured by a lien on real estate which generally entitles the lender to payments of contractual principal and interest that do not increase based on the underlying operating results of a property.

2.23 A participating mortgage is an investment also secured by a lien on real estate which generally consists of three parts: (1) "base interest" payments at contractually stated fixed or floating rates; (2) "contingent interest" payments where the lender is paid a percentage of property net operating income or cash flow after debt service; and (3) "additional contingent interest" which is in the form of lender participation in the appreciation in value of the underlying property.

2.24 Usually the loan terms of a participating mortgage are set somewhat more favorably than what a non-participating mortgage interest rate would be quoted on the same property. Common terms historically include loan-to-value ratios of up to 90%, base interest rates which are lower than comparable non-participating mortgages, and sometimes the structure may allow for a deferral of interest between the basic interest coupon and some lower "pay rate," typically during lease-up. The deferral may be paid as and when the net operating income is sufficient to do so, or may be added to the loan balance and be payable in full only at maturity.

2.25 The contingent interest component of a participating mortgage often represents a right to some portion of the adjusted net cash flow of a property. Typically, certain expenses such as legal or other professional fees related to ownership rather than property matters, limited borrower overhead, and other similar expenses are not permitted as deductions from gross income for determining the amount in which the lender participates in contingent interest. Often a reserve for replacements, or for tenant improvements, leasing commissions and capital expenditures is set aside from net operating income before the lender participates in the remainder.

2.26 The additional contingent interest or equity conversion component often specifies a hurdle rate which the lender is entitled to reach from basic interest, contingent interest and additional contingent interest before the borrower participates in any proceeds from sale.

Accounting for Non-Participating Mortgage Loans

2.27 Non-participating mortgage loans should be carried on the balance sheet at their market value. The difference between market value and the adjusted cost basis of a mortgage loan is the unrealized gain or loss associated with the asset. Changes in market value from period to period are reported as changes in unrealized gain or loss on the income statement which is presented separately from net investment income. These gains or losses are realized upon the disposal of an investment. The ability to recognize a sale of a mortgage loan is governed by the guidance provided in SFAS No. 140.

2.28 The initial cost basis of a non-participating mortgage loan should include all direct costs of originating or obtaining the loan, consistent with the treatment of acquiring investments in real estate assets and SFAS 91. This includes acquisition fees paid to investment advisors associated with the closing of a new investment.

2.29 The carrying amounts of interest receivables currently due (generally one year or less) are generally considered to approximate market value. Therefore, for market value reporting, interest receivable and currently due may be reported at its undiscounted amount provided that the results of discounting the carrying amount would not be material and that receipt can reasonably be expected.

2.30 Interest income associated with any non-participating mortgage loan is reported in net investment income. Valuation adjustments are reported as unrealized gains and losses. The recognition of interest income should be based on the contractual terms of the loan unless the loan is considered impaired under authoritative accounting guidance for loans. For impaired loans, the recommended method for interest recognition is the cash method, where payments of interest received are recorded as interest income provided that the amount does not exceed that which would have been earned based on the contractual terms of the loan. For mortgage loans with fixed and determinable rate changes, interest income should be accounted for based on when the change contractually occurs rather than using an effective interest or straight-line method-the effect of such changes as is typical under the historical cost accounting model. The effect of the contractual change is, instead, recognized in the adjustment to market value.

2.31 The market value of a non-participating mortgage loan and any accrued non-current interest should be based on the discounted value of the total future expected net cash flows. The selection of an appropriate discount rate should reflect the relative risks involved and interest rates charged for similar receivables. The determination of market value must also take into consideration the underlying collateral, credit quality of the borrower and any related guarantees as well as the specific terms of the loan agreement. The market value of the note and any accrued non-current interest should not exceed the value of the underlying collateral and any related guarantees. Accrued non-current interest is typically added to the note balance whereas current interest receivable is separately disclosed.

2.32 Modification of mortgage terms should be accounted for through an adjustment of value.

Accounting for Participating Mortgage Loans

2.33 Because of the participation feature inherent in these loans, and the fact that the lender usually provides a significant portion, if not all, of the funds necessary to acquire, develop, or construct the property, most the accounting for participating mortgages will be classified under GAAP as Acquisition, Development and Construction (ADC) Arrangements and subject to should be determined based upon the guidance in the February 10, 1986 AICPA Notice to Practitioners - ADC Arrangements; and Emerging Issues Task Force (EITF) Issue No. 86-21, *Application of the AICPA Notice to Practitioners Regarding Acquisition*,

Development and Construction Arrangements to Acquisition of an Operating Property. ~~In the case where a participating mortgage is considered to be an ADC arrangement under this guidance, the investment in the participating mortgage would be considered to be equivalent to~~ may have the characteristics of either a loan, a non-controlling equity investment in a joint venture, ~~or a controlling interest subject to consolidation~~ for accounting purposes, ~~depending on the facts and circumstances. As such~~For the latter two categories, the investment should be accounted for using the guidance provided in the discussion of joint ventures appearing in section 2.39 ~~or of real estate in 2.04, respectively.~~

2.34 Participating mortgages not considered to be ~~ADC arrangements~~ joint ventures or investments in real estate in accordance with the guidance outlined above, should also be carried on the balance sheet at their market value. The difference between market value and the adjusted cost basis of a mortgage loan is the unrealized gain or loss associated with the asset. Changes in market value from period to period are reported as changes in unrealized gain or loss on the income statement which is presented separately from net investment income. These gains or losses are realized upon the disposal of an investment. The ability to recognize a sale of a mortgage loan is governed by the guidance provided in SFAS No. 140.

2.35 The initial cost basis of a participating mortgage loan should include all direct costs of obtaining the loan, consistent with the treatment of acquiring direct investments in real estate. This includes acquisition fees paid to investment advisors associated with the closing of a new investment.

2.36 Interest income associated with any participating mortgage loan is reported in net investment income. Valuation adjustments are reported as unrealized gains and losses. The recognition of base interest income should be based on the contractual terms of the loan unless the loan is considered impaired under authoritative accounting guidance for loans. For impaired loans, the recommended method for interest recognition is the cash method where payments of interest received are recorded as interest income provided that the amount does not exceed that which would have been earned based on the contractual terms of the loan. For mortgage loans with fixed and determinable rate changes, interest income should be accounted for based on when the change contractually occurs rather than ~~using an effective interest or straight-lining method as typical~~ the effect of such changes as is typical under the historical cost accounting model. Contingent interest income ~~from operating cash flows~~ is also recorded by the lender as part of net investment income. Additional contingent interest ~~received from disposal or refinancing of the underlying property~~ is recorded as part of realized gains and losses.

2.37 The market value of a participating mortgage investment is equal to the discounted value of the total future cash flows expected from the investment. The value of the mortgage may not exceed the value of the underlying real estate plus any qualifying guarantees. The discount rate used in the valuation should reflect the risk/return characteristics of the participating investment structure. The valuation may be performed with different discount rates for the different sources of the anticipated cash flows; a “debt” rate may be associated with the nonparticipating cash flows and an “equity” rate may be associated with the participation cash flows. In all cases the economic substance of the transaction must be taken into account in determining the value of the investment.

2.38 Any modification of mortgage terms should be accounted for through an adjustment of value.

Investments in Joint Ventures

2.39 The joint venture is a relatively common form of ownership for institutional investors in real estate. The venture is usually a legally formed general partnership or limited liability company between the investor and a real estate developer/operator.

2.40 Real estate investments are often structured as joint venture ownership because of the ability to share risks and rewards among the participants. The institutional partner is typically responsible for most, if not all, of the cash to be invested in the project. Such investment may be in the form of equity capital, loans to the venture, or both. In consideration for the cash investment which is disproportionate to its stipulated ownership interest, the institutional partner is generally entitled to a preferential distribution of cash flow equal to a preferred return on the capital invested and interest on loans, and to a priority return of its capital investment from a sale or refinancing. Amounts generated by the joint venture in excess of these preferences and priorities are distributed to the participants in accordance with their stipulated ownership interests.

~~2.41 On the spectrum of ownership forms, the joint venture is between owned real estate on the one hand and participating mortgage loan on the other. The economic terms of a real estate joint venture investment often appear to be similar to those of a participating mortgage loan, particularly as they relate to cash distribution priorities. On the other hand, joint ventures are similar to investments in owned real estate in that the investor typically participates in operating decisions for the project. This control may be shared with the venture partner, but the degree of involvement is often significant compared to a passive lender. Investors should consider existing authoritative guidance to determine whether an investment in a joint venture is controlling or not.~~

~~2.42 NCREIF requires that the equity method of accounting be used for investment in joint ventures.~~ As noted previously, if an investor owns a controlling equity interest in a joint venture, the investor should consolidate the accounts of the joint venture as if the joint venture were a subsidiary. In such cases, the accounting discussed in the investments in real estate assets section should be followed.

2.43 For purposes of this section, it is also presumed that the joint venture does not meet the criteria for loan accounting set out in the February 10, 1986 *AICPA Notice to Practitioners - ADC Arrangements*. These criteria should be assessed prior to concluding on the accounting treatment for investments in joint ventures.

2.44 Finally, this section assumes that the cost method of accounting would not be applicable to most joint venture investments. The cost method is only applicable when the investment is a limited partnership interest that is so minor that the limited partner may have virtually no influence over partnership operating and financial policies. (The SEC has taken a position that “so minor” means not more than 3%.)

Accounting for Joint Venture Investments

2.45 Investments in joint ventures should be carried on the balance sheet at their market value. The difference between market value and the adjusted cost basis of an investment in a joint venture is the unrealized gain or loss associated with the asset. As is discussed in greater detail below, changes in market value from period to period are reported as changes in unrealized gain or loss on the income statement which is presented separately from net investment income. These gains or losses are realized upon the disposal of an investment. However, in order to record a realized gain, the sale is required to meet the criteria of SFAS No.66. Gains which are deferred in accordance with SFAS No. 66 continue to be reported as unrealized.

2.46 The initial cost basis of an investment in a joint venture should include all direct costs of obtaining the investment, consistent with the treatment of acquiring direct investments in real estate. This includes acquisition fees paid to investment advisors associated with the closing of a new investment.

2.47 The initial cost basis of an investment in a joint venture is then subsequently adjusted to include the investor's share of joint venture income/loss recorded in accordance with the equity method, as well as capital contributions and distributions. To the extent that the investor has advanced funds to the joint venture in the form of loans, all outstanding principal and non-current interest receivable should also be included in the cost basis. The aggregate investment should be presented on the balance sheet as a single caption, "Investment in Joint Venture".

2.48 ~~Institutional p~~Partners in joint ventures should record as investment income only their share of the venture's net investment income or loss, determined in accordance with generally accepted accounting principles on the market value basis of accounting (exclusive of items such as depreciation, amortization and free rent, as appropriate). AICPA Statement of Position (SOP) 78-9 suggests that stipulated allocation ratios should not be used if cash distributions and liquidating distributions are determined on some other basis (i.e., income should be allocated first on behalf of any preferred returns or interest, and then to the respective partners in proportion to their contractual ownership interests, etc.). Inter-company items, such as interest on loans by a partner to a venture, should be eliminated to the extent of the investor's economic interest in the venture, as if the investee were consolidated.

Determination of Joint Venture Market Value

2.49 The determination of the market value of an investment in a joint venture requires (1) the appraisal of the underlying assets and liabilities of the joint venture, and (2) the performance of a hypothetical liquidation in accordance with the distribution provisions of the joint venture agreement. Total proceeds currently distributable to the institutional partner under this hypothetical liquidation represent the market value of the investment.

[Accounting for guarantees](#) is addressed by FASB Interpretation 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*.

2.50 If a partner has made a "definitive decision to sell" a partial interest in a real estate joint venture, the market value of the partner's interest in the venture should consider the estimated costs that will be incurred to sell the interest. Similarly, if the joint venture has made a "definitive decision to sell," its real estate assets, the market value of the joint venture's assets and liabilities should take into account estimated costs of sale at the venture level.

Recommended Financial Statement Disclosures

Disclosures for Real Estate Assets

2.51 The following items should be disclosed in a financial statement presentation that includes investments in real estate assets:

- Basis of presentation for the reporting entity's financial statements.
- Policy for determining estimated market value of real estate investments (e.g., valuation

- methodology).
- Policy related to the capitalization of tenant improvements, tenant allowances, leasing costs and commissions.
- ~~Policy related to the treatment of capital improvements during the interim periods between market value updates.~~
- A schedule of real estate investments, including the market value and cost of real estate assets by property, and including product type and geographic data.
- Disclosure of vulnerability due to certain concentrations. Statement of Position 946, “Disclosure of Certain Significant Risks and Uncertainties,” requires disclosure of concentrations in the market or geographic area and concentrations in the volume of business transacted with a particular customer and concentrations in revenue from particular products and services, etc. Applicable examples might include concentrations by property type or geographic region or tenant concentration.
- Policy related to ~~the recording revenue recognition, including the treatment~~ of minimum rents, tenant expense reimbursements, percentage and overage rents, free and stepped rent, ~~and when such recording is discontinued.~~
- Disclosure of future minimum rental income to be received under noncancelable operating leases for each of the following 5 years and thereafter.
- Disclosure of contingent rentals earned during the reporting periods (i.e., overage rents, reimbursable operating costs and real estate taxes, etc.).

Disclosures for Investments in Mortgage Loans

2.52 The financial statements of an entity that holds investments in either participating or non-participating mortgage loans should include disclosures that contain a description of the mortgage loan receivables held, which should include relevant details for each loan or class of loans related to the following:

- Participation feature, if a participating mortgage loan
- Rate of interest (stated rate and current pay rate, if different)
- Maturity date
- Repayment provisions
- Collateral held (including any cross-collateral provisions)
- Prepayment penalty provisions

Disclosures for Joint Venture Investments

2.53 The following items should be disclosed in a financial statement presentation that includes joint venture investments:

- Policy for the recording of estimated market value of joint venture investments (e.g., valuation methodology).
- ~~Policy for the treatment of capital additions between the dates of market appraisals.~~
- Policy related to the recording of investments in real estate partnerships and ventures.
- Policy for the recording of income from the investment in real estate partnerships, corporations, joint ventures and trusts.
- The significance of joint venture investments should be considered in evaluating the extent of

disclosures of the financial position and results of operations of an investee. If the investor has more than one investment, disclosures wholly or partly on a combined basis may be appropriate. The following disclosures are generally applicable to the equity method of accounting for an investment:

- Name of each investee and the percentage of ownership, the market value and cost basis of the investment, the accounting policies of the investor with respect to the investments, and the difference, if any, between the amount at which an investment is carried and the amount of underlying equity in net assets and the accounting treatment of the difference.
 - Condensed summary financial data (assets, liabilities and results of operations) of the investees either individually or in groups, as appropriate, when the aggregate of such investments is material in relation to the financial position or results of operations of the investor~~meets the significant subsidiary test provided in SEC Regulation S-X Rule 1-02 (w)~~. Disclosure of the basis of accounting presented for the financial data (e.g., market value or historical cost) is required. Also see section 3.08 for recommended disclosures relating to the debt underlying each investment.
- Additional funding commitments to the joint venture.
 - Guarantees of joint venture liabilities, if any.
 - Existence of buy/sell provisions, put provisions, etc. provided for in the venture agreement

3. Notes Payable

3.01 Real estate properties are often partially financed using long- or intermediate-term loans whereby the real estate is pledged as collateral for the loan. In many mortgage loan arrangements, the lender has no other recourse against the borrower; however, some arrangements provide for credit enhancements in the form of guarantees or additional pledges from the borrower. Real estate properties can also be financed through long- or intermediate-term loans whereby owners with high credit standing or prearranged lines of credit may be able to borrow on an unsecured basis or using a loan which is secured by collateral other than a real estate mortgage. Financing terms available in the marketplace for a given loan may vary over time, based on capital market factors, as well as changing business risks associated with the collateral and/or the entity.

3.02 [Reserved for future use.]

3.03 Unless prohibited by accounting principles generally accepted in the United States of America, notes payable are required to be carried at market value as described in paragraph 3.05. The market value of notes payable should be reported separately from that of the related encumbered assets. Changes in market financing terms should not affect the valuation of collateral. Adjustments to the estimated market value of notes payable should be reported as unrealized gain (loss) in the statement of operations. Gains and losses realized upon settlement of notes payable, net of transaction and prepayment costs, if any, should be reported as realized gain (loss) in the statement of operations

3.04 For notes payable that are prohibited by US GAAP to be carried at market value, disclosures are required to be provided with quarterly and annual client financial reporting which disclose the market value of notes payable in accordance with paragraph 3.05. Such disclosures should include a description of the supplemental accounting policy for notes payable.

3.05 The market value of notes payable is based on the amount at which the liability could be settled or exchanged in a current transaction between knowledgeable, unrelated willing parties, exclusive of direct transaction costs. Direct transaction costs include only those costs, or that portion of such costs, that are unrelated to changes in effective interest rates since the date of origination of a loan.

3.06 Unrealized losses on notes payable should generally be recognized when interest rates decline below contractually fixed rates. Generally, unrealized gains on notes payable should only be recognized if the related gain would be realized in an assumed transaction with a third party on the balance sheet date

3.07 When management makes a decision to prepay or to exchange a loan associated with a specific investment, net asset value should be adjusted to reflect transaction costs, including the full cost of prepayment and yield maintenance costs.

Recommended Financial Statement Disclosure

3.08 The following items should be disclosed in a financial statement presentation that includes notes payable:

- The valuation methodology should be disclosed in the notes to the financial statements.
- Principal balance outstanding
- Rate of interest
- Maturity date
- Repayment provisions
- Collateral and cross-collateral arrangements
- Prepayment penalty provisions
- Guarantees on indebtedness
- Significant covenants
- Relevant distribution restrictions
- Convertibility features
- Defaults
- Aggregate annual payments of mortgage principal due for the following 5 years
- Principal balance of loan and related real estate market value where real estate value is below debt market value
- Methodology used for estimating market value

4.4. Derivative Financial Instruments Interest Hedging/Capping Contracts

4.01 Real estate is often financed through variable rate mortgages. In an effort to nullify the effect of fluctuations in interest rates and maintain a neutral position with interest fluctuations, the borrower may purchase either interest hedging-swaps, collars, Treasury locks, floors or capping contracts. The contract does not have to be assigned to a specific property or loan but can also be established in connection with a portfolio of properties. These contracts also involve an up-front cost and generally are transferable to other parties.

4.02 ~~The interest hedging or capping contract~~ All derivative financial instruments should be carried at market value with the change in market value being recorded as unrealized gain or loss. The approach used for estimating the market value of interest hedging/capping-rate protection contracts should be consistent with the investment vehicle's approach for estimating the market value of notes payable. The contract should be carried as an asset or liability, as market value indicates, and should be adjusted to market value each reporting period as interest rates change. Any costs associated with obtaining the ~~program contracts~~ should be capitalized. The interest element of such costs should be ~~and~~ amortized as a component of interest cost, with the unamortized amounts included in the cost basis of the asset (liability) to be valued.

~~The accounting for payments made to terminate a derivative contract early depends upon whether or not the related debt remains outstanding. If the derivative is terminated upon early repayment of the debt, the amount of the termination payment should be recorded as a realized loss. If the derivative is terminated, but the related debt remains outstanding, the termination payment should be capitalized as a cost of the debt, and amortized as a component of interest expense over the remaining term of the related debt. The valuation of such cost is considered as part of the valuation of the related debt. Accordingly, unrealized gains and losses should be recognized based on the valuation approach used to estimate the market value of notes payable.~~

Recommended Financial Statement Disclosure

4.03 The following items should be disclosed in a financial statement presentation that includes interest hedging/capping-rate protection contracts:

- The valuation methodology should be disclosed in the notes to the financial statements.
- The notional amount of the contract.
- Contract period.
- Cash requirements of the payer and payee.
- The amount of accounting loss the enterprise would incur if any party to the financial instrument failed completely to perform according to the terms of the contract.
- If the financial instruments have significant concentrations of credit risk, disclosure of the activity, region or economic characteristic that identifies the concentration of credit risks.

5. Other Assets and Liabilities

5.01 There are a variety of other assets and liabilities that may result from real estate investment activities.

Examples of other assets include prepaid expenses, supplies inventory, utility deposits, escrow deposits, equipment, etc. Examples of other liabilities include accounts payable, accrued expenses such as accrued real estate taxes, insurance, repairs and maintenance, utilities and professional fees, and other liabilities such as security deposits, unearned rental income, and fees payable among others.

5.02 Other assets or liabilities that are short-term in nature (i.e., expected to be settled within one year of the date of the financial statements) may be reported on the balance sheet at their undiscounted values. This is due to the fact that because of the short-term nature of these items, their undiscounted balances are considered to approximate their market values.

5.03 Other assets or liabilities which are longer-term in nature (i.e., expected to be settled more than one year from the date of the financial statements) should generally be reported at their market value. If there is an active market with quoted market prices for other assets and liabilities held, this information should be used in determining market value. In the absence of quoted market prices, market values should be determined using discounted cash flow analysis as long as such values approximate the amount that would be received or paid in a current transaction. The amounts and timing of the cash inflows and outflows associated with other assets and liabilities must be estimated and discounted back to a present value. The discount rates used should reflect a current market rate commensurate with the risks of the specific asset, or the current market rates applicable to liabilities of similar duration or risk.

5.04 For those assets or liabilities that do not have future cash flows associated with them (e.g., equipment), the use of an estimated current net sales price or current settlement amount may be appropriate. Regardless of the methodology utilized, care must be exercised in evaluating other assets and liabilities to ensure that they have not already been included in the valuation of real estate investments.

5.05 Like real estate investments, changes in the market value of other assets and liabilities from period to period are reported on the income statement as unrealized gains and losses which are reported separately from net investment income. Unrealized gains and losses become realized when the underlying asset or liability is settled or resolved.

Receivables

5.06 Various operating transactions may result in a note or accounts receivable (other than mortgage loan receivables and related interest which are discussed separately). These notes receivable may be short-term or long-term in nature.

5.07 The undiscounted carrying value of short-term receivables (e.g., less than one year to maturity) generally approximates market value due to the relatively short period of time between the reporting date and the expected realization. The use of an undiscounted value is acceptable provided that the results of discounting would be immaterial. An allowance should be established based upon the amount of the receivable expected to be recoverable. Any such allowance is charged to net investment ~~income~~, income; however, industry practice varies as to whether the allowance is charged against revenue or as an operating expense. Any receivables that are considered in the valuation of the real estate asset should not be established as such amounts are already included in the valuation of the real estate asset.

5.08 The market value of longer-term receivables should be estimated by discounting the expected future cash flows expected to be received (including interest payments) using a current market rate of similar receivables commensurate with the risks of the specific receivables. Similar receivables are those that have comparable credit risk and maturities. An allowance should be established based upon the present value of the ultimate amount to be recovered. Consideration should be given to any underlying collateral.

Deferred Costs

5.09 An entity may incur certain costs that are related to its organization. Statement of Position 98-5, Start-up Costs, requires that organization costs and the costs of other startup activities be expensed as incurred. Cost may also be incurred in connection with obtaining financing for the entity - either secured or unsecured. Historical cost accounting provides for these costs to be capitalized and amortized over the term of the loan.

5.10 Organization costs do not result in an asset having value outside of the entity, and therefore, they should be expensed as incurred.

5.11 The cost basis of amounts incurred in connection with obtaining financing (professional fees, commissions, points, interest rate buy-downs, etc) should be capitalized, ~~and amortized as a component of interest expense over the term of the related debt using the effective interest rate method.~~ The interest element of such costs should be amortized as a component of interest expense over the term of the related debt using the effective interest rate method. The valuation of ~~such~~ financing costs is considered as part of the valuation of the related debt. Accordingly, unrealized gains and losses should be recognized based on the valuation approach used to estimate the market value of notes payable.

Other Liabilities

5.12 Other liabilities may include contingent consideration that is part of an investment at the time of the acquisition. Contingent consideration should be recognized and measured at fair value at the acquisition date and each reporting date, rather than recognized and measured as an adjustment to the purchase price in the subsequent periods in which the contingency is resolved.

Recommended Financial Statement Disclosures

5.123 The following items represent the recommended financial statement disclosures related to other assets and liabilities:

- Disclosure of the significant components of other asset and liability balances, if material, including accounts receivables and accrued expenses.
- For notes receivable, provide a description of the note, which should include relevant details for each loan or class of loans related to the following:
 - Rate of interest
 - Maturity date
 - Repayment provisions
 - Collateral held (including any cross-collateral provisions)
 - Prepayment penalty provisions

- Policy related to the recording of organization costs and financing costs.

6. Other Revenues and Expenses

6.01 Revenues and expenses directly related to real estate investments held by investors are discussed within the individual sections related to investments in real estate assets, investments in mortgage loans and investments in joint ventures. Other revenues and expenses not directly related to real estate investments should generally be recognized in accordance with applicable authoritative accounting literature. Items whose treatment is unique to the market value basis of accounting, as well as items whose accounting may be consistent with a historical cost accounting model, but are of particular importance to real estate investors, are discussed below.

Real Estate Advisory Fees

6.02 Real estate advisory fees may include acquisition, asset management, disposition, financing and incentive fees. Property management fees are a normal operating expense of real estate assets, and are expensed in the property operations section of the Statement of Operations. Leasing fees and commissions are discussed in the real estate assets section.

6.03 Acquisition fees are considered as part of the acquisition cost of a property and, therefore, are included in the cost basis of the real estate asset as are other acquisition-related costs. They are included as part of the cost when comparing cost to value to determine realized or unrealized gain or loss.

6.04 Asset management fees should be generally expensed in the current period.

6.05 Disposition fees are typically paid when a property is sold and calculated as a percentage of the sales price. The fee generally compensates a real estate advisor for their services rendered in a property disposition, including sales marketing, negotiating, and closing. As this fee is not earned until the work is performed or substantially performed, the fee is generally recognized as a cost of sale in the period in which the property is sold.

6.06 Disposition fees related to investments which are considered “assets to be disposed of” in accordance with SFAS 144 should be recognized as a reduction in the value of the asset during the period in which the criteria of SFAS 144 are met (~~see related real estate assets section~~). Disposition fees which are substantively incentive fees should be measured and recognized as incentive fees.

6.07 Incentive fee arrangements and calculations vary widely, but generally these fees are paid after a predetermined investment performance return has been attained. For example, these fees may be payable upon actual or constructive sale of a real estate investment or portfolio, or may be payable when cash flows from operating or capital distributions exceed some threshold.

6.08 Incentive fees should be recognized if they would be payable if all assets were sold and liabilities were settled at the balance sheet date. The calculation of the amount earned is specific to the related real estate advisory agreement, but generally the calculation should assume that the property or portfolio is

liquidated at its market value as of the reporting date and cash proceeds are distributed to the investors. A liability should be established for the amount of the incentive fee, although not necessarily currently payable.

6.09 The related impact of recording a liability for an incentive fee should be either (1) reflected as a component of net investment income, if the fee resulted from operating results; or (2) reflected as a component of unrealized gain/loss, if the fee resulted from changes in value. Where incentive fees are based on both operating results and changes in value, the related impact should be allocated to the applicable components based on the substance of the incentive fee arrangements.

Realized and Unrealized Gains and Losses

6.10 The periodic valuation of real estate investments and other non-current assets and liabilities, including mortgage indebtedness, pursuant to the market value basis of accounting, results in changes in the reported value of investments and other assets owned, and liabilities owed. These changes are reported in the Statement of Operations as unrealized gains and losses. Gains and losses are realized upon the disposal of an investment or the settlement of liabilities; however, sales transactions must also meet the gain recognition criteria set forth in SFAS No. 66. Gains which are deferred in accordance with SFAS No. 66 continue to be reported as unrealized.

6.11 Realized gains and losses and the change in unrealized gains and losses are reported separately from net investment income in the Statement of Operations. Further, the portion of the change in unrealized gains and losses attributable to asset dispositions or the settlement of liabilities, (i.e., the realization of previously reported unrealized gains/losses), is separately reported or otherwise disclosed, as appropriate for each period presented in the financial statements.

6.12 The distinction between realized and unrealized recognition is not applied to items of Net Investment Income (i.e., revenue and expenses), even if such items are not currently receivable or payable. Recognition of revenue is a function of the earnings process, and expenses are recognized as incurred. Information related to changes in the balances of receivables and payables is included in the Statement of Cash Flows. To the extent recognized revenue is considered uncollectible, the estimated allowance is charged to Net Investment Income.

6.13 A separately disclosed realized gain should be recognized on the extinguishment of debt when real estate is transferred to a lender in satisfaction of non-recourse debt. This gain may be recognized as an unrealized gain prior to reconveyance. ~~Further discussion of this issue is provided in the section on Notes Payable.~~

Recommended Financial Statement Disclosures

6.14 The following items should be disclosed in a financial statement presentation that includes advisory fees and/or other related party transactions:

- Disclose the contractual arrangements and the accounting policies for all advisory fees including acquisition, disposition and incentive fees.
- Typically such fees are earned by an affiliate of the reporting entity. Thus, the related party disclosure must be included in the notes to the financial statements.

6.15 Disclosure should also be provided of the facts and amounts surrounding any transaction with entities that are directly owned by the venture partners, sponsors, investment advisors, or other entities related by common ownership. Examples may include the following:

- Portfolio and asset management fees accrued and/or paid
- Leasing commissions, incentive or management fees accrued and/or paid
- Properties purchased or sold
- Receivables/payables with related parties

~~The following section has been deleted in its entirety. Illustrative Financial Statement examples will be included in the NCREIF web site.~~

7. Illustrative Financial Statements

~~7.01 Illustrative financial statements are available on the NCREIF website. These financial statements are illustrative only and are intended to provide an illustrative format for annual financial statement reporting under the market value basis of accounting. The illustrative statements reflect common financial statement presentation and disclosure items typically used in the institutional real estate investment community. Disclosures included in the illustrative financial statements are not intended to be comprehensive and are not intended to establish preferences among alternative disclosures. For specific reporting issues encountered by an individual investment vehicle, the applicable technical accounting literature should be consulted to provide guidance for the appropriate presentation and disclosure in the financial statements.~~

The accompanying illustrative financial statements are intended to provide an illustrative format for annual financial statement reporting under the market value basis of accounting. The illustrative statements reflect common financial statement presentation and disclosure items typically used in the institutional real estate investment community. For specific reporting issues encountered by an individual investment vehicle, the applicable technical accounting literature should be consulted to provide guidance for the appropriate presentation and disclosure in the financial statements.