

REIS ADOPTING RELEASE

**Summary of Chapter 2: Fair Value Accounting and Reporting Standards and
REIS Guidance: Fair Value Accounting Policy Manual**

Issued by the Real Estate Information Standards Council in Conjunction with the Real
Estate Information Standards Board

March 26, 2009

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Executive Summary

This adopting release summarizes the changes made to the Fair Value Accounting and Reporting Standards (Chapter 2) of the REIS Standards and the related REIS Guidance contained in the Fair Value Accounting Policy Manual. These revisions were deemed necessary in order to keep the REIS Standards current as changes are made to U.S. generally accepted accounting principles (U.S. GAAP) and to further promote and enhance compliance with and verifiability of the REIS Standards.

The most significant changes to Chapter 2 are the following:

- Update for new accounting standards
- Acknowledge two Fair Value reporting models utilized in the Industry¹: the Operating Reporting Model and the Non-Operating Reporting Model and
- Identify Fund, Investment and Property level information in order to provide consistency in reporting REIS compliant data.

In order to be in compliance with Chapter 2 of the REIS Standards each Fund² on a quarterly basis, must present, Fair Value U.S. GAAP based financial statements and must elect SFAS 159, *The Fair Value Option* for all notes payable liabilities.

During the fourth quarter in 2008, the REIS Council formed a task force to assess industry sentiment with respect to the REIS standard requirement to elect *The Fair Value Option* (SFAS 159) for all debt. A total of 32 management firms (including 18 of the top 20 firms (by assets under management per *Pensions and Investments*)) and 24 plan sponsor organizations (representing \$1.8 trillion in total plan assets) were interviewed. Based upon this interview process, the task force recommended to the REIS Council that the required standard be modified to a requirement for open-end funds only (because of trading) and a recommendation for all other funds. In addition, all funds would be required to provide enhanced disclosures on debt valuation as if the Fund had adopted SFAS 159 so that investors receive the fair value information they desire or require. The task force assessed industry sentiment to the proposal. The REIS Board and Council determined that the standard should not be revised until guidance is developed to address the issues raised. A task force has been formed to address such guidance which is expected during the second quarter in 2009.

The REIS Board and Council will periodically review the standards included in Chapter 2 and modify the standards as appropriate. U.S. GAAP is the foundational standard for accounting within the REIS Standards and as such, compliance with Chapter 2 is predicated on compliance with GAAP. Where options exist under GAAP, the REIS Standards aim to promote consistency and comparability. The purpose of the fair value accounting standards contained within Chapter 2 is to provide current accounting standards that are useful to users and preparers of financial information and that can be complied with and subject to independent verification. These standards promote

¹ As used herein, Industry refers to the private, tax-exempt, U.S. institutional real estate investment community.

² As used within the REIS Standards, Fund includes all commingled funds (open-end and closed-end) and single investor investment accounts (a.k.a. separate accounts)

consistent, comparable, transparent, and verifiable financial information to the U.S. private, tax-exempt institutional real estate community.

Modifications to the REIS Standard

As of March 26, 2009, Chapter 2, Fair Value Accounting and Reporting Standards is included in the REIS Standards as follows:

Chapter 2: Fair Value Accounting Standards

Preface

2.01 Introduction

2.01(a) As noted in the Preface to the REIS Standards: The Standards incorporate by reference governance from its foundational standards³ bodies, where applicable, to the institutional equity real estate investment management community (Industry). The REIS Standards provide guidance in specific areas where accounting standards are silent or subject to interpretation. Within the REIS Standards, GAAP is one such foundational standard. The REIS Standards do not contradict GAAP and **compliance with the REIS Standard for Accounting is predicated on compliance with GAAP**. Where options exist under GAAP, the REIS Standards aim to promote consistency and comparability. The purpose of the fair value accounting standards contained within this chapter of the REIS Standards is to provide current accounting standards and related guidance (in the form of required and recommended practices) that are useful to users and preparers of financial information and that can be complied with and subject to independent verification. These standards promote consistent, comparable, transparent, and verifiable financial information to the U.S. private, tax-exempt institutional real estate community. Therefore, this chapter is organized in sections and provides required and recommended accounting practices at three levels:

- **Fund**: To comply with the Chapter 4, Fund Reporting requirement for, at a minimum, quarterly Condensed Fair Value GAAP financial reporting (Section 4.13) and the annual requirement for Fair Value GAAP financial statements and footnotes (Section 4.14). In addition, Chapter 4 also recommends an annual audit (Section 4.14).
- **Investment**: To provide consistent detailed investment information generally contained in the footnotes to the financial statements as well as within performance measures, which require investment-specific disclosures.

³ As noted in the REIS Constitution, foundational standards are established standards from authorized bodies including but not limited to valuation standards established through Uniform Standards of Professional Appraisal Practice (USPAP), accounting standards established by accounting principles generally accepted in the United States of America (GAAP), and the performance measurement and reporting standards promulgated by the CFA Institute known as the Global Investment Performance Standards (GIPS).

- Property: To provide consistent accounting information across funds that is used in attribution analysis (e.g., Portfolio Characteristics per section 4.22 of Chapter 4), benchmark reporting, and reporting to the NCREIF Property Index (NPI).

2.02 Required Practices

Listed below are the required practices to be utilized for accounting information for each reporting period.

- US GAAP Fair Value based financial statements are required at the Fund level of reporting.
- Election of the Fair Value Option for all debt is required at the Fund, Investment and Property level.

2.03 History of Accounting Models for Tax-Exempt Investors

2.03(a) The fundamental premise for fair value accounting models 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, Statement of Financial Accounting Standard (SFAS) 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, Governmental Accounting Standards Board (GASB) Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, requires government-sponsored pension plans to present investments at fair value in their financial statements. Defined benefit and government-sponsored pension plans often invest in real estate and/or real estate companies. Accordingly, 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.

2.03(b) In 1983, in response to the needs of the investor community, the NCREIF Accounting Committee developed guidelines for fair value accounting to be used by the institutional real estate investment industry. The fundamental premise for fair value based accounting models is based on existing U.S. accounting standards which require that certain investments held by tax-exempt investors, including defined benefit pension plans and endowments are reported at fair value. This model is supported by SFAS 35 and GASB 25 and is referred to throughout Chapter 2 of the REIS Standards as the **Operating Model**.

2.03(c) Over the years, investments made by fund managers have become increasingly complex and it has become apparent that many of these Funds 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”). This authoritative guidance supports the use of a fair value accounting model for investment companies. Some Funds use this model as their Fair Value GAAP model for accounting and reporting. This accounting model is referred to throughout Chapter 2 of the REIS Standards as the **Non-Operating Model**.

2.03(d) At present, some funds use the Operating Model as their fair value reporting model and some funds use the Non-Operating Model. Varying interpretations of these two models exist. In addition, other fair value accounting models exist that are not referenced within this chapter. One such model is promulgated by the International Financial Reporting Standards (IFRS). Currently, the REIS Standards are applicable to Funds that are required to present U.S. Fair Value GAAP financial information only. **The determination of the appropriate model to be used by a Fund is made by fund management in consultation with their auditors.**

2.04 The REIS Fair Value Accounting Policy Manual

The REIS Fair Value Accounting Policy Manual provides additional guidance to support the required and recommended practices contained in this Chapter 2.

2.05 Effective Date

The effective date for implementation of this Chapter 2, Fair Value Accounting Standards is for quarters commencing after March 31, 2009, with early adoption encouraged.

REIS Guidance

As of March 26, 2009 the Fair Value Accounting Policy Manual which provides guidance for implementation of the REIS Standards for Chapter 2, is issued as shown in Appendix C of this adopting release.

Appendix A: Alternatives Considered and Basis for Conclusions Reached

Recording of Costs of Originating and Obtaining Debt

A.1 U.S. GAAP is the foundational standard for accounting within the REIS Standards and as such, compliance with Chapter 2 is predicated on compliance with GAAP. In the case where options exist under GAAP or when guidance provided within GAAP is subject to interpretation, the REIS Standards may stipulate a specific interpretation of GAAP in order to promote consistency and comparability.

- A.2 During the most recent exposure draft process, the REIS Council proposed an interpretation of Paragraph 3 of SFAS 159, which states, “upfront costs and fees related to items for which the fair value option is elected shall be recognized as earnings as incurred and not deferred”. The REIS Council proposed that “earnings” within this paragraph means a component of net investment income and reported within interest expense on the Statement of Operations.
- A.3 Under existing GAAP, entities which have not adopted SFAS 159, debt costs will continue to be deferred and amortized to interest expense using the effective interest method. The REIS standards require the election of SFAS 159. In order to remain comparable to other institutional investment classes, the REIS Council concluded that it was critical to continue to treat such costs consistently. In addition, the REIS Council concluded that comparability amongst periods was also important and the adoption of SFAS 159 should not change where an entity’s debt costs should be recorded and therefore it was not appropriate to re-categorize the cost within the Statement of Operations or treat the expense as a component of unrealized loss.
- A.4 Respondents to the Exposure Draft were nearly equally divided as to the proper treatment for debt costs. Most frequently cited as a reason to consider these costs within the valuation adjustment is to provide consistent treatment with costs to acquire an asset, which are capitalized. Proponents of this treatment also cited that the proposed REIS Fair Value Accounting Policy Manual indicated that capitalization of the costs of an investment was a reasonable interpretation of the definition of “earnings” as described in SFAS 141 R for users of the Operating Reporting Model as well as consistent with the requirements of paragraph 2.41 of the AICPA Investment Company Guide which is used for accounting by investment companies. (See Appendix B for additional comments relating to the treatment of debt costs.)
- A.5 Under either method, net asset value should remain the same. Disclosures within the financial statements would enable the user to identify the treatment used which should facilitate reconciliation of the classification differences. Accordingly, no specific interpretation for the treatment of debt costs is encompassed as a required standard within Chapter 2. The Guidance to Chapter 2 recommends the treatment as a component of Net Investment Income (“NII”) however either treatment would allow for compliance with the REIS Standard to present fair value U.S. GAAP financial statements.

Appendix B: Public Comment Process

B.1 On November 20, 2008, the REIS Council and Board issued an exposure draft entitled: Proposed Chapter 2, Fair Value Accounting Standards (including Proposed Revised Fair Value Accounting Policy Manual) which was exposed to the public through January 20, 2009. A total of twelve responses were received, 11 from investment advisory firms and 1 consulting firm. The key issues and questions considered by industry participants as part of the public comment process for the Chapter 2 and Manual exposure draft are summarized below.

B.2 Treatment of Upfront Debt Costs: SFAS 159 Paragraph 3, states: upfront cost and fees related to items for which the fair value option is elected shall be recognized as earnings as incurred and not deferred”. The REIS Standards require that the direct expensing of such cost are to continue

to be reported within interest expense on the Statement of Operations and therefore as a component of net investment income. Do you agree with the REIS Standards requirement of recording debt costs of obtaining loans as a component of interest expense and net investment income on the statement of operations? If not, provide a description of an alternative approach you would recommend.

The respondents were divided as to whether the proposed standard was appropriate. Those that agreed with the proposed standard indicated that the treatment was consistent with the previous accounting treatment of such costs under GAAP, which was to defer and amortize the costs into interest expense. The full write off in year 1 of a debt issuance or refinancing was, in essence, a timing issue.

One respondent indicated that the treatment was appropriate because the fees were not transaction costs because they do not represent the incremental direct cost to transfer the liability but are attributable to the pricing of the liability. That respondent further added that the REIS Standards should require debt valuations to incorporate a “fully loaded market interest rate”, (i.e., market rate plus fee load), in order to encapsulate the full cost of replacing that debt and to better align the cost and benefit of the loan amongst investors (i.e., particularly for open-end funds where trading occurs).

One respondent noted that although they felt the treatment was appropriate, the required categorization as interest expense in the Statement of Operations was too prescriptive and the Standard should require only that such costs be considered a component of Net Investment Income (NII).

Those respondents who indicated the treatment to expense these costs through NII was not appropriate contended that consideration of such costs within the valuation component was consistent with the treatment of costs to acquire an asset, which are capitalized. These respondents contend that such costs are part of the capitalization of the real estate and not of its operations. To report such items within NII would distort net operating income. They further contend that the previous treatment (amortization over the life of the loan) was appropriate as the expense was being recognized over the benefit period of the associated debt.

One respondent indicated that SFAS 159’s reference to “earnings” allows for significant policy discretion in terms of how to recognize interest expense. The respondent indicated that within our Industry, “earnings” has two components: NII and realized/unrealized gains and losses.

After consideration of the comments received the REIS Council concluded that the standard to require the write off of such costs to NII was not appropriate given that certain respondents believed GAAP does not prescribe such a treatment. Disclosures required within GAAP will facilitate comparisons of differing accounting treatments used by Funds. However, the guidance to Chapter 2

recommends to expense as incurred such costs as a component of NII in order to remain comparable to other institutional investment classes.

B.3 Issues to Address or Clarify and User Friendliness: Are there any other issues to the Chapter or Manual that need to be addressed or clarified? The formats of the Proposed Chapter 2 and Manual have been substantially revised in order to be more useful, foster comparability between the Operating Model and the Investment Company Model and to promote compliance and verifiability within the institutional real estate industry. Do you agree that the revised formats are more user-friendly? If you do not agree, please suggest how the Chapter and Manual can be made more useful for your reporting needs.

Although respondents overwhelmingly agreed that the revised formats were more user-friendly, they made numerous suggestions for clarifications and issues to address. As a result of these comments, the REIS Council made some changes to both the Chapter and Manual. In addition, some suggestions will be taken under advisement and considered within future updates to the Chapter and Manual. A summary of the significant changes made and those to be considered in future updates is provided below.

B.4 Changes Made:

Included Commentary on Debt Valuation Guidance Anticipated in Quarter 2, 2009. Respondents suggested that the Chapter and Manual should make reference to the work being done by the Debt Valuation Task Force. This reference is included within Chapter 2.

Re-Named Operating Model and Investment Company Model to Operating Reporting Model and Non-Operating Reporting Model: In our Industry two different models of reporting are generally used. These have been described as the Operating Model and the Investment Company Model. It was suggested that the term “Investment Company Model” be changed. In addition, it was pointed out that the key differences in the two models relates to reporting issues as net asset value is expected to be the same under either model. Therefore, the Chapter and Manual makes reference to the “Operating Reporting Model” and the Non-Operating Reporting Model.

Include Side-by-Side Comparisons of Operating Reporting Model and Non-Operating Reporting Model: Respondents suggested that user-friendliness and clarity would be enhanced if a side-by side comparison of the two reporting models were included in the Manual. This comparison will be prepared in a future version expected in 2009.

Included Sample Financial Statements for the Non-Operating Reporting Model: These sample financial statements are included as an Appendix to the Manual.

Updated Sample Financial Statements for the Operating Reporting Model for SFAS 160. SFAS 160, *Noncontrolling interests in Financial Statements – an Amendment of ARB 51* changes the presentation and disclosure of noncontrolling interests (formerly known as minority interest) within the financial statements. The Operating Reporting Model and Non-Operating Reporting Model financial statements have been updated for SFAS no. 160.

B.5 Considerations for Future Updates

Suggestions which will be considered in future updates to the Manual or other REIS Standards and guidance include the following:

- Incorporate Debt Valuation Guidance
- Provide clearer delineation of guidance associated with each reporting model
- Address foreign currency adjustments for international funds
- Establish an IFRS subcommittee
- Comparison of two reporting models

B.6 Use of Both (Reporting) Models: Do you use financial reports using both the Operating (Reporting) Model and the Investment Company (Reporting) Model (renamed to Non-Operating Reporting Model)? If the answer is yes, do you think the REIS Standards and Guidance within the Manual fosters comparability between the two models? Is comparability necessary? If comparability is necessary and the REIS Standards do not provide it, what could be done to foster further comparability?

Half of the respondents who answered this question indicated that they use both models. Of those yes respondents, half of them indicated that they thought that the REIS Standards and Guidance within the Manual fosters comparability, the other half did not respond to the question. Only 2 respondents answered the question as to whether comparability was necessary: one indicating yes and one indicating no. Suggestions to foster comparability are included within the Issues to Address or Clarify and User Friendliness section above.

B.7 Promoting Compliance and Verifiability: Will chapter 2 promote compliance and verifiability within the institutional real estate industry? Please explain your answer and provide specific suggestions which would promote compliance and verifiability.

Respondents who indicated that compliance and verifiability were promoted within Chapter 2 gave the following reasons:

- *Chapter outlines accounting policies for areas of GAAP where there may be inconsistent practices or interpretation*
- *Chapter recognizes multiple (reporting) models which do not require the manager to go outside of GAAP to accomplish their financial reporting*
- *Additional REIS requirements are few and are clearly stated*

Suggestions made to further promote compliance and verifiability support the notion to adhere to (Fair Value) GAAP as much as possible and include:

- *Strive to maintain options currently allowed within GAAP; consider strongly recommending a position and educate towards a position.*
- *Do not set standards which conflict with the reporting requirements of GAAP.*
- *Consistent with other asset classes, develop metrics to examine and compare financial information-do not focus on changing the financial statements.*
- *Incorporate IFRS. (It should be noted that the REIS Standards are U.S. based)*

Appendix C: REIS Fair Value Accounting Policy Manual

REIS Guidance

REIS Fair Value Accounting Policy Manual

Issued: March 2009

REIS GUIDANCE

REIS FAIR VALUE ACCOUNTING POLICY MANUAL March 2009

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- 1. Illustrative Financial Statements for Operating Reporting Model**
- 2. Illustrative Financial Statements for Non-Operating Reporting Model**

REIS Fair Value Accounting Policy Manual

1. Introduction

1.01 Purpose

The purpose of the REIS Fair Value Accounting Policy Manual (Manual) is to provide additional guidance to support the required and recommended accounting practices within the REIS Standards. As noted in Chapter 2, Fair Value Generally Accepted Accounting Principles (FV GAAP) is the foundational standard for accounting. Therefore, the REIS Standard for Accounting does not contradict GAAP, and **compliance with the REIS Standard for Accounting is predicated on compliance with U.S. GAAP Fair Value based financial information.**

1.02 Organization of Manual

In addition to this introduction, this Manual has separate sections that address the three levels of accounting within Chapter 2: Fund Level, Investment Level, and Property Level. Included in the appendices are a comparison of the Operating Reporting Model and Non-Operating Reporting Model, and illustrative financial statements for both the Operating Reporting Model and Non-Operating Reporting Model.

1.03 Terminology

Certain terms as used herein are defined as follows:

- Fund: Includes all commingled funds and single-investor investment accounts; a fund has one or more investments
- Investment: A discrete asset or group of assets held for income, appreciation, or both and tracked separately
- Property: A real estate asset
- Financial Accounting Standards Board: FASB
- Statement of Financial Accounting Standards: SFAS
- Governmental Accounting Standards Board: GASB
- American Institute of Certified Public Accountants: AICPA
- Accounting principles generally accepted in the United States of America: U.S. GAAP or GAAP.

1.04 Fair Value

1.04(a) The REIS Standards require fair value financial information, and accordingly, certain information reported for Funds must be reported at fair value. Property and investment information may be maintained on a basis other than fair value (e.g., historical cost, tax basis, cash basis). This information must be converted to fair value for incorporation into the Fund Report. (See Chapter 4, Fund Level Reporting Standards for more information.)

1.04(b) Fair value as defined under SFAS No. 157, *Fair Value Measurement*, “is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” Accordingly, a primary condition of fair 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.

1.05 Relevant Accounting and Auditing Guidance

1.05(a) Relevant accounting and auditing guidance contained in official pronouncements issued through **May 31, 2008**, has been considered in the development of this edition of the Manual. This includes relevant guidance issued up to and including the following:

- SFAS 141R *Business Combinations*
- SFAS 157, *Fair Value Measurements*
- SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities including an Amendment to SFAS 115*
- SFAS 160 *Noncontrolling interests in Financial Statements – an Amendment of ARB 51*
- Other FASB Statements through and including SFAS 163 *Accounting for Financial Guarantee Insurance Contracts – an Interpretation of SFAS 60*
- FASB Interpretations through Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an interpretation of SFAS Statement No. 109*, as amended by FASB Staff Positions Nos. FIN 48-1, “Definition of Settlement in FASB Interpretation No. 48,” and FIN 48-2, “Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises”
- FASB Technical Bulletins (TB) through TB 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*
- FASB Staff Position SOP 07-1-1, which indefinitely delays the effective date of SOP 07-1
- Other FASB Staff Positions issued through February 1, 2008, including FASB Staff Position No. FAS 157-2, “Effective Date of FASB Statement No. 157,” FASB Staff Position No. FIN 46(R)-7, “Application of FASB Interpretation No. 46(R) to Investment Companies”
- FASB Emerging Issues Task Force (EITF) consensus positions adopted at meetings of the EITF through EITF 08-5 *Issuers Accounting for Liabilities Measured at Fair Value through a Third Party Credit Enhancement*
- Practice Bulletins (PB) through PB No. 15, *Accounting by the Issuer of Surplus Notes*

1.06 Disclaimers

1.06(a) This Manual and related appendices do not discuss the application of all GAAP that are relevant to the preparation of financial statements of real estate entities. This Manual and related appendices are directed primarily to those aspects of the preparation of financial

statements that are unique to private institutional real estate entities or those aspects that are considered particularly significant to them.

- 1.06(b) For specific reporting issues, the applicable technical literature should be consulted to provide the most recent guidance for the appropriate accounting and disclosure in the financial statements. The purpose of the Manual is to support the REIS Standards for accounting by providing guidance on issues particular to the real estate industry for which no such guidance is available or guidance is unclear and to assist in providing comparable information for users of financial statements and financial information.
- 1.06(c) Users of this Manual and the related appendices should consider pronouncements issued subsequent to those listed above to determine their effect on entities covered by this Manual.

2. Fund Level Accounting

2.01 Introduction

- 2.01(a) The Fund Level represents the aggregation of all investments. (A Fund may include only one investment or multiple investments.) In addition, it includes items that are not specifically allocated to a single investment (i.e., “unallocated”) as well as portfolio level debt.
- 2.01(b) As described within Chapter 2, the REIS Accounting Standards address two accounting models currently utilized in the industry for U.S. GAAP fair value based reporting: the **Operating Reporting Model** and the **Non-Operating Reporting Model**. The determination of the appropriate fair value reporting model to use is made by the entity’s management in consultation with the entity’s auditors. Within the REIS Standards, the requirement is to report US GAAP Fair Value based financial statements. (See sections 4.13 and 4.14 of Chapter 4, Fund Reporting Standards, for more information.)
- 2.01(c) The information contained in this section is separated based upon the applicable reporting model.

2.02 Net Assets

- 2.02(a) Net assets represent the excess of the fair value of investments owned, cash, receivables and other assets over the liabilities of the Fund. SFAS 160 *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51* was issued in December 2007 with the objective of improving the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. An entity should perform an assessment of their noncontrolling interests’ rights and consider whether the noncontrolling interest is a redeemable equity security within the scope of EITF Topic No. D-98, “*Classification and Measurement of Redeemable Securities*”.
- 2.02(b) SFAS 160 is effective for fiscal years beginning on or after December 15, 2008. The statement should be applied prospectively as of the beginning of the fiscal year in which the statement is initially adopted, except for the presentation and disclosure requirements. The presentation and disclosure requirements shall be applied retrospectively for all periods presented, as follows:
- 2.02(b.1) The noncontrolling interest (previously known as minority interest) shall be reclassified to equity, as amended by this Statement. For the Operating Reporting Model, this requires such noncontrolling interests to be included within net assets.
- 2.02 (b.2) Consolidated net income shall be adjusted to include the net income attributed to the noncontrolling interest.

- 2.02(b.3) Consolidated comprehensive income shall be adjusted to include the comprehensive income attributed to the noncontrolling interest.
- 2.02(b.4) The disclosures in paragraphs 38 and 39 of ARB 51, as amended by FASB 160, are required to be provided. (See Appendix 2.)

2.03 Non-Operating Reporting Model

Note: Users of the Operating Reporting Model for Funds should skip to section 2.04 below

2.03(a) Introduction and Position within the GAAP Hierarchy

Funds which are considered Investment Companies follow the AICPA Audit and Accounting Guide – *Audits of Investment Companies* (the “Investment Company Guide”). These Funds may prepare financial statements using the Non-Operating Reporting Model. Consistent with the Operating Reporting Model, investments must be reported at Fair Value. Net Asset Value (i.e., the total fair value of all assets reduced by the total fair value of all liabilities) is the same under both reporting models.

2.03(b) Requirement to Elect SFAS 159, The Fair Value Option

In order to be in compliance with the REIS Standards, SFAS 159 must be elected for all notes payable, including portfolio level debt. Further information can be found in Sections 4.04 and 4.05.

2.03(c) Consolidation and Applicability of FIN 46(R)

Sections 7.04 through 7.06 of the Investment Company Guide provide guidance on the use of consolidation by investment companies. FSP No. FIN 46(R)-7, “Application of FASB Interpretation No. 46(R) to Investment Companies,” states the effective date for applying the provisions of Interpretation 46 or Interpretation 46(R) is deferred for investment companies that are not subject to SEC Regulation S-X, Rule 6-03(c) (1), but are currently accounting for their investments in accordance with the specialized accounting guidance in the Investment Company Guide.

2.04 Operating Reporting Model

2.04(a) Introduction

- 2.04(a.1) The fundamental premise for fair value based accounting models is based on existing authoritative accounting standards which require that certain investments held by tax-exempt investors, including defined benefit pension plans and

endowments are reported at fair value. Statement of Financial Accounting Standard (SFAS) 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, Governmental Accounting Standards Board (GASB) Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, requires government-sponsored pension plans to present investments at fair value in their financial statements. Defined benefit and government-sponsored pension plans often invest in real estate and/or real estate companies. Accordingly, 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.

- 2.04(a.2) Both consolidation and equity method accounting are used in the Operating Reporting Model. Consistent with the Non-Operating Reporting Model, investments must be reported at fair value. Net asset value (i.e., the total fair value of all assets reduced by the total fair value of all liabilities) should be the same under both reporting models (excluding noncontrolling interests). (See Appendix 1 for a comparison of the reporting models.) 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 and underlying property operations. Net investment income is a measure of operating results. 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, tenant inducements, and other replacement costs. Rental revenue is recognized when it is contractually billable to tenants. Expenses are generally recognized when the obligation is incurred. Certain expenses may be based on the investment vehicle's unrealized change in net asset value, including, for example, incentive management fees, and are recognized as a component of the unrealized gain or loss.

2.04(b) Position within GAAP Hierarchy

Accounting rules state that in the absence of authoritative guidance, prevalent accounting practices in an industry form the basis for GAAP in that industry. The lack of applicable authoritative accounting guidance specific to the real estate industry had caused fair value accounting practices to constitute GAAP in the institutional real estate investment industry and lead to the creation of the Operating Reporting Model.

2.04(c) Requirement to Elect SFAS 159, The Fair Value Option

Consistent with the Non-Operating Reporting Model, in order to be in compliance with the REIS Standards, SFAS 159 must be elected for all notes payable liabilities, including portfolio level debt. (Further information can be found in Sections 4.04 and 4.05).

2.04(d) Consolidation: Applicability of FIN 46(R)

Under the Operating Reporting Model 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. Investors should consider existing authoritative guidance to determine whether an investment in an investee (e.g., joint venture) is controlling or not. 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). In accordance with Paragraph 4b of FIN 46(R), an employer shall not consolidate an employee benefit plan subject to the provisions of FASB Statements No. 87, *Employers' Accounting for Pensions*. After the issuance of FIN 46, the FASB indicated that it did not intend for the requirements of the FIN 46 to supersede the guidance for accounting for employee benefit plans, including the guidance in SFAS 35. Management should consult with their auditors to assess the applicability of FIN 46R to their reporting model.

2.04(e) Consolidation: Accounting

2.04(e.1) Under the Operating Reporting Model, the financial statements of controlled investees must be consolidated with those of the investor. Depending on the type of entity, investors that use the Operating Reporting Model must apply relevant GAAP literature, which include, but are not limited to, SFAS 160, ARB 51, EITF Issue No. 04-5, and SOP 78-9, to determine if it must consolidate its joint venture investments. While in general the ownership of a greater than 50% voting interest in a Fund is considered to be an indication of control, many joint venture real estate investments contain complex governance arrangements that make assessments of control difficult. All factors must be considered in making a determination of whether consolidation of an investee is appropriate. Under the Operating Reporting Model, if investments in entities are not deemed to be controlling interests then the equity method of accounting should generally be followed.

2.04(e.2) Under the Operating Reporting Model, real estate assets either owned directly by a Fund or reported through the consolidation of an investee are recorded on the balance sheet at their fair value. If the investee is less than 100% owned, a corresponding credit to noncontrolling interest is recorded at fair value for the noncontrolling interest in the investment. The difference between fair value and the adjusted cost basis of an investment is the unrealized gain or loss associated with the asset, and if applicable, the non-controlling interest. Changes in fair value from period to period are reported as changes in unrealized gain or loss on the statement

of operations, 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.

- 2.04(e.3) Key changes of the consolidation process required by SFAS 160 include that the noncontrolling interest continues to be attributed its share of losses even if that attribution results in a deficit noncontrolling interest balance. This statement also requires the acquirer to measure a noncontrolling interest in the acquiree at its fair value at the acquisition date. These are significant changes from previous guidance.
- 2.04(e.4) In the footnotes or in the statement of changes in net assets an entity is required to provide a reconciliation of the beginning and the ending carrying amounts of (1) net assets attributable to the parent entity (2) net assets attributable to the noncontrolling interest, and (3) total net assets.
- 2.04(e.5) In the footnotes, SFAS 160 also requires a separate schedule to be provided that shows the effects of any changes in a parent's ownership interest in a subsidiary on the equity attributable to the parent. Entities are required to disclose both a reconciliation of net assets (par. 38c) and a separate schedule of changes in ownership. (par. 38d).

2.04(f) Equity Method Accounting

Investors in investees (e.g., partners in joint ventures) accounted for under the equity method of accounting should record as investment income only their share of the venture's net investment income or loss, determined in accordance with GAAP on the fair 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.). Intercompany items, such as interest on loans by an investor to an investee should be eliminated to the extent of the investor's economic interest in the venture, as if the investee were consolidated.

3. Investment Level Accounting

3.01 Introduction

- 3.01(a) This section outlines the required accounting policies to be followed for accounting at an investment level for interests in real estate investments. While, at the Fund Level, funds may follow different fair value accounting and reporting models (i.e., Operating Reporting Model or the Non-Operating Reporting Model), the following are items that are considered applicable to all fair value models.
- 3.01(b) See the Property Level Accounting in section 4 for information relating to realized and unrealized gains and losses.
- 3.01(c) The underlying real estate assets of a Fund 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.
- 3.01(d) Investments in real estate are made using various investment structures. Included in this section of this Manual is guidance relating to the following investment structures:
- Directly owned real estate (see Property Level Accounting in Section 4)
 - Investments in Non-Participating Mortgage Loans Receivable
 - Investments in Participating Mortgage Loans Receivable
 - Investments in Joint Ventures

3.02 Investments in Mortgages and Other Loans Receivable: General Discussion

- 3.02(a) There are primarily two types of mortgage loan investments held by Funds: non-participating and participating mortgage loans. A non-participating mortgage loan is an investment secured by a lien on real estate that generally entitles the lender to payments of contractual principal and interest that do not increase based on the underlying operating results of a property.
- 3.02(b) A participating mortgage is an investment also secured by a lien on real estate that 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.
- 3.02(c) 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.

- 3.02(d) 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.
- 3.02(e) The additional contingent interest or equity conversion component often specifies a hurdle rate that the lender is entitled to reach from basic interest, contingent interest and additional contingent interest before the borrower participates in any proceeds from sale.

3.03 Accounting for Non-Participating Mortgage Loans Receivable

- 3.03(a) Non-participating mortgage loans receivable should be carried on the balance sheet at their fair value. The difference between fair value and the adjusted cost basis of a mortgage loan is the unrealized gain or loss associated with the asset. Changes in fair value from period to period are reported as changes in unrealized gain or loss on the statement of operations, 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.
- 3.03(b) The initial cost basis of a non-participating mortgage loan should include all direct costs of originating or obtaining the loan; however, the entity’s management needs to assess if there is a value of such costs under SFAS 157 or if an unrealized loss should be recognized upon acquisition of the loan. Such costs include acquisition fees paid to investment advisors associated with the closing of a new investment.
- 3.03(c) The carrying amounts of interest receivables currently due (generally one year or less) are generally considered to approximate fair value. Therefore, for fair value reporting, interest receivable 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 assured.
- 3.03(d) Interest income associated with any non-participating mortgage loan receivable 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-line method. However for the Non-Operating Reporting Model EITF 99-20, *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets*, should be followed. 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.

- 3.03(e) The fair 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 fair 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 fair 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.
- 3.03(f) Modification of mortgage terms should be accounted for through an adjustment of value.

3.04 Accounting for Participating Mortgage Loans Receivable

- 3.04(a) 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, accounting for participating mortgages should be determined based upon the guidance in the February 10, 1986 *AICPA Notice to Practitioners – ADC Arrangements*; and EITF Issue No. 86-21, *Application of the AICPA Notice to Practitioners Regarding Acquisition, Development and Construction Arrangements to Acquisition of an Operating Property*. A participating mortgage 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. For the latter two categories, the investment should be accounted for using the guidance provided in the discussion of joint ventures appearing in Section 3.05 or in the discussion on real estate in Section 4.02.
- 3.04(b) Participating mortgages not considered joint ventures, or investments in real estate in accordance with the guidance outlined above, should also be carried on the balance sheet at their fair value. The difference between fair value and the adjusted cost basis of a mortgage loan is the unrealized gain or loss associated with the asset. Changes in fair value from period to period are reported as changes in unrealized gain or loss on the statement of operations, 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.

- 3.04(c) The initial cost basis of a participating mortgage loan should include all direct costs of making the loan consistent with SFAS 91. However, the entity's management needs to assess the fair value of the loan under SFAS 157 or if an unrealized loss should be recognized on day one of holding the loan. Such costs include acquisition fees paid to investment advisors associated with the closing of a new investment.
- 3.04(d) 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-line method. However for the Non-Operating Reporting Model EITF 99-20, *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets*, should be followed. 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.
- 3.04(e) The fair 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.
- 3.04(f) Any modification of mortgage terms should be accounted for through an adjustment of value and recorded through the unrealized gain/loss in the statement of operations.

3.05 Investments in Joint Ventures: General

- 3.05(a) Joint ventures are a common form of ownership for funds and institutional investors in real estate. The venture is typically a legally formed limited partnership or limited liability company between the fund/institutional investor and a real estate developer/operator.

3.05(b) Real estate investments are often structured as joint ventures because these structures provide the ability to share risks and rewards among the participants. The fund/institutional investor typically own the greater share of the joint venture and provide most of the equity invested into the project. Such investment may be in the form of equity capital, loans to the venture, or both. The fund/institutional investor's operating partner is typically the general partner in the venture who is a real estate developer/operator in the specific project type. In consideration for the cash investment that 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.

3.06 Investments in Joint Ventures: Accounting

- 3.06(a) The appropriate treatment for accounting for joint ventures in the primary financial statements depends upon the reporting model utilized. See the Fund Section included in this Manual for a discussion of appropriate treatment and sources of additional guidance.
- 3.06(b) When joint ventures are not consolidated, the difference between fair value and the adjusted cost basis of an investment in a joint venture is the unrealized gain or loss associated with the investment. As is discussed in greater detail below, changes in fair value from period to period are reported as changes in unrealized gain or loss on the statement of operations, which is presented separately from net investment income. Unrealized gains or losses are recognized as realized gains or losses upon the disposal of an investment.
- 3.06(c) The initial cost basis of an investment in a joint venture should include all direct costs of obtaining the investment. This includes acquisition fees paid to investment advisors associated with the closing of a new investment.
- 3.06(d) 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, 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." SFAS No. 95, *Statement of Cash Flows (AC C25)*, requires dividends received (returns on investments) to be classified as cash inflows from operating activities. Receipts from returns of investments are classified as cash inflows from investing activities.
- 3.06(e) The investment in a joint venture is then subsequently adjusted to include the changes in fair value as measured in accordance with SFAS 157 and is reflected on the statement of operations as an unrealized gains or loss during the period the change in fair value occurs. 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 investment account. The aggregate investment should be presented on the schedule of

investments as a single investment. The REIS Fund Reporting Standards require an annual presentation of a Schedule of Investments (see Chapter 4.16).

3.06(f) The determination of the fair value of an investment in a joint venture requires: (1) The valuation of the underlying assets and liabilities of the joint venture; and (2) the analysis of a hypothetical liquidation at fair value in accordance with the distribution provisions of the joint venture agreement. Consideration should be given to all incentive fees and preferred returns included in the joint venture agreement in determining the hypothetical liquidation at fair value of the joint venture. Fair value is defined by SFAS 157 as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Transaction costs are not included in determining the fair value of the investment. Hypothetical liquidation at fair value may not necessarily reflect the exit price of an entity's joint venture investment. Consideration should be given to what a market participant would be willing to pay. Other valuation considerations for joint venture investments are evaluated separately by the REIS Valuation Committee.

3.07 *Accounting for Contingent Consideration*

3.07(a) For all acquisitions one should recognize as of the acquisition date, all of the assets acquired and liabilities assumed that arise from contingencies related to contracts (referred to as contractual contingencies), and measure them at their acquisition-date fair values.

3.07(b) For all other contingencies (referred to as *noncontractual contingencies*), the acquirer shall assess whether it is more likely than not as of the acquisition date that the contingency gives rise to an asset or a liability as defined in Concepts Statement 6. If that criterion is met as of the acquisition date, the asset or liability arising from a noncontractual contingency shall be recognized at that date, measured at its acquisition-date fair value. If that criterion is not met as of the acquisition date, the acquirer shall not recognize an asset or a liability at that date. The acquirer shall instead account for a noncontractual contingency that does not meet the more-likely-than-not criterion as of the acquisition date in accordance with other GAAP, including SFAS 5 *Accounting for Contingencies*, as appropriate.

3.07(c) Probability weighted discounted cash flows or other complex valuation models may be required to value such contingent considerations. A Fund needs to further determine if such consideration should be recorded as an asset, liability, derivative instrument or equity.

3.07(d) Under the Operating and Non-Operating Reporting Models, all acquisitions should be valued at fair value and therefore include as assessment of contractual and noncontractual contingencies.

3.08 *[Reserved for Future Use]*

3.09 *Financing Costs*

3.09(a) Costs may be incurred in connection with obtaining financing for the Fund or the investment — either secured or unsecured. SFAS 159 (paragraph 3) states that “upfront costs and fees related to items for which the fair value option is elected shall be recognized in earnings as incurred and not deferred.” The REIS standards require the adoption of SFAS 159. (See Sections 4.04 and 4.05) Under existing GAAP, for those entities that have not adopted SFAS 159, debt costs will continue to be deferred and amortized to interest expense using the effective interest method. In order to remain comparable to other institutional investment classes, it is recommended that, subsequent to the adoption of SFAS 159, such financial costs continue to be treated as a component of net investment income.

3.10 Real Estate Advisory Fees

3.10(a) General

Real estate advisory fees may include acquisition, asset management, disposition, financing, and incentive fees.

3.10(b) Acquisition Fees

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 under both the Operating Reporting model and Non-Operating Reporting Model. In circumstances where an investment company or pension plan is making an investment, transaction costs associated with the investment acquisition should be capitalized as part of the cost of the investment.

3.10(c) Asset Management Fees

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

3.10(d) Disposition Fees

Disposition fees are typically paid when an investment is sold and calculated as a percentage of the sales price. The fee generally compensates a real estate advisor for their services rendered in an investment 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 investment is sold. Disposition fees that are substantively incentive fees should be measured and recognized as incentive fees.

3.10(e) Incentive Fees

3.10(e.1) 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.

- 3.10(e.2) 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 investment or fund is liquidated at its fair 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.
- 3.10(e.3) The related impact of recording a liability for an incentive fee should be either (1) reflected as a component of the investment's net investment income, if the fee resulted from operating results; or (2) reflected as a component of the investment's unrealized gain/loss, if the fee resulted from changes in fair value.
- 3.10(e.4) Where incentive fees are based on both operating results and changes in fair value, the related impact should be allocated to the applicable components based on the substance of the incentive fee arrangements.

4. Property Level Accounting

4.01 Introduction

- 4.01(a) This section outlines the required accounting policies to be followed for underlying real estate investments accounted for at the property level, in order to provide consistent accounting information across funds for attribution analysis (e.g., Portfolio Characteristics per Chapter 4.22), benchmark reporting, and reporting to the NCREIF Property Index (NPI). In addition, under the Operating Reporting Model, financial statements prepared for wholly owned properties are accounted for in this manner and utilized accordingly for consolidation purposes.
- 4.01(b) 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. Under the fair value basis of accounting, real estate assets are carried on the balance sheet at their estimated fair value. Changes in fair value from period to period are recognized as unrealized gains or losses until sale or disposition of an interest in the real estate investment.
- 4.01(c) Net investment income is not intended to approximate net income determined under the historical cost basis of accounting. Among other differences, net investment income under the fair value financial reporting model does not 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.

4.02 Determination of Real Estate Fair Value

- 4.02(a) SFAS No. 157 focuses on how to measure fair value. SFAS 157 does not introduce any new requirements mandating the use of fair value; instead, it unifies the meaning of fair value within existing GAAP and expands disclosures about fair value measurements. It also introduces a fair value hierarchy to classify the source of information used in fair value measurements (i.e., market based or non-market-based inputs).
- 4.02(b) SFAS 157 (paragraph 5) defines fair value as, “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” This definition retains the exchange price notion in earlier definitions of fair value. However, the definition focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price). The fair value of an asset is a market based approach. Therefore, the fair value measurement should be based on the highest and best use assumptions that market participants would use in pricing the asset or liability even if the intended use by the reporting entity is different.
- 4.02(c) The fair value measurement in SFAS 157 assumes that the transaction to sell the asset occurs

in the principal market for the asset or in the absence of a principal market, the most advantageous market for the asset. The principal (or most advantageous) market (and thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities.

- 4.02(d) SFAS 157 requires that a fair value measurement should maximize the use of observable inputs (defined as Level 1 and 2 inputs) and minimize the use of unobservable inputs (Level 3). If the fair value measurement has significant Level 2 and 3 inputs, Level 3 footnote disclosures are necessary. Most real estate valuations are expected to include significant unobservable (Level 3) inputs. Such valuations should reflect the reporting entity's assumptions that market participants would use, including assumptions about risk. Such assumptions should be developed based on the best information available without undue cost and effort. It is the source of the input that drives the classification, not approach or specialist used to determine fair value. For instance, an external appraiser's valuation of a property utilizing a discounted cash flow model based on the specific cash flows of said property would be considered a Level 3 input.
- 4.02(e) The fair 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. (See the REIS Property Valuation Standards for more information.)
- 4.02(f) Under SFAS 157, transaction costs associated with future sales should be evaluated from a market participant perspective. For entities that follow SFAS 35 *Accounting and Reporting by Defined Benefit Pension Plans*, SFAS 157 Appendix E7 provides guidance on fair value and requires fair value to include an estimate of costs to sell.
- 4.02(g) The fair 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 fair value debt is assigned to the cost basis of the related debt. The real estate and the related mortgage are to be shown separately on the balance sheet.
- 4.02(h) SFAS No. 144 also requires that the cost basis of "impaired" assets be written down to fair value. Under the REIS Standards, the impairment accounting guidance provided by SFAS 144 is not applicable to the cost basis of real estate assets in a fair value basis presentation.
- 4.02(i) SFAS No. 144 also 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 fair value under either SFAS 35, GASB Statement 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.

4.03 Determination of the Cost Basis of Real Estate Assets

- 4.03(a) The initial cost basis of a real estate asset includes direct costs of acquiring the real estate asset under both models. 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 Projects*, provides guidance relating to the appropriate cost capitalization criteria. Direct costs of acquisition are considered as part of the acquisition cost of a property. They are included as part of the cost when comparing cost to value to determine realized or unrealized gain or loss under the Non-Operating Reporting model. Regardless of whether an entity follows the Operating or Non-Operating Reporting Model for the presentation of its financial statements, the investment in real estate should be treated in a manner consistent with paragraph 2.41 of the AICPA Investment Company Guide, and therefore, such costs should continue to be capitalized and be considered as part of the acquisition cost of the property. The valuation of the underlying investment under SFAS 157 may result in an unrealized loss on day one.
- 4.03(b) Because real estate investments are recorded at fair value each reporting period, none of the components (building, equipment, improvements, lease costs, in-place lease value, lease inducements, lease origination costs, etc.) are depreciated or amortized.
- 4.03(c) The initial cost basis of a real estate asset should be subsequently adjusted for additional capital costs such as tenant and building improvements, tenant allowances, tenant inducements, 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 fair 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.
- 4.03(d) 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 fair value of the asset against an investor's investment in it.
- 4.03(e) Capitalized costs associated with a real estate asset are not depreciated or amortized, as depreciating or amortizing would just be offset by an increase in unrealized appreciation in the same or subsequent periods.

4.04 Loans Payable

- 4.04(a) Real estate investments are often partially financed using long- or intermediate-term loans whereby the real estate property is pledged as collateral for the loan. In many 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 investments can also be financed through 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 the underlying real estate investments.

- 4.04(b) SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities — including an amendment of FASB Statement No. 115*, was issued in February 2007 and permits entities to choose to measure many financial instruments at fair value on a contract-by-contract basis.
- 4.04(c) **The REIS Standards require that the fair value option under SFAS 159 be selected for each note payable instrument (i.e., Fund, Investment, and Property).** The adoption of SFAS 159 is effective for years beginning after November 15, 2007. For existing notes payable the election to adopt The Fair Value Option must be made at the beginning of the fiscal year that commences after November 15, 2007. Upon adoption of SFAS 159, the difference between the carrying amount and the fair value of notes payable shall be recognized as a cumulative effect adjustment to the opening balance of net assets.
- 4.04(d) The fair value of loans payable should be reported separately as liabilities. Subsequent to the initial adoption, adjustments to the estimated fair value of loans payable should be reported as unrealized gain (loss) in the statement of operations. Gains and losses realized upon settlement of loans payable, net of transaction and prepayment costs, if any, should be reported as realized gain (loss) in the statement of operations.
- 4.04(e) The fair value of loans payable is determined by SFAS 157 and is based on the amount at which the liability could be transferred in an orderly transaction between market participants at the measurement date, exclusive of transaction costs. The fair value definition of SFAS 157 focuses on the price that would be paid to transfer the liability (an exit price), not the price that would be received to assume the liability (an entry price). Therefore, if a market participant was to assume debt, interest expense incurred to date would not be assumed by the buyer and would remain the liability of the entity.

4.05 Direct Transaction Costs of Loans Payable

- 4.05(a) SFAS 159 (paragraph 3) states that “upfront costs and fees related to items for which the fair value option is elected shall be recognized in earnings as incurred and not deferred.” Therefore, transaction costs related to loans payable are recorded as a reduction in earnings incurred in the statement of operations. Transaction costs refer to the incremental direct costs to transact in the principal (or most advantageous) market for the liability. Upon adoption of SFAS 159, paragraph 26 states, “the difference between the carrying amount and the fair value of eligible items for which the fair value option is elected at the effective date shall be removed from the balance sheet and included in the cumulative-effect adjustment. Those differences may include, but not limited to: unamortized deferred costs, fees, premiums, and discounts, valuation allowances, and accrued interest, which would be reported as part of the fair value of the eligible item.” Subsequent to the adoption of SFAS 159, transactions costs should be expensed as incurred.
- 4.05(b) Prior to the adoption of SFAS 159 such transaction costs related to the issuance of debt or refinancing were deferred and amortized to interest expense. As of the beginning of an

entity's fiscal year commencing after November 15, 2007, it is recommended that such costs are recorded as a component of net investment income as incurred.

- 4.05(c) Unrealized gains and losses on notes payable should generally be recognized when market interest rates or credit spreads fluctuate relative to contractually fixed rates or variable rate credit spreads.

4.06 Derivative Financial Instruments

- 4.06(a) Real estate is often financed through variable rate loans. In an effort to manage the risks associated with fluctuations in market interest rates and to maintain a more neutral position during market interest rate fluctuations, the borrower may purchase derivative financial instruments (derivatives), such as interest swaps, collars, Treasury locks, floors, or capping contracts. The contract can be assigned to a specific property or loan or they can be established in connection with a portfolio of investments. These contracts also involve an up-front cost and generally are transferable to other parties.
- 4.06(b) All derivative financial instruments should be carried at estimated fair value with the change in fair value being recorded to earnings in accordance with SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*.
- 4.06(c) The approach used for estimating the fair value of interest rate protection contracts should be consistent with SFAS 157. The contract should be carried as an asset or liability, as fair value indicates, and should be adjusted to fair value each reporting period. Any transaction costs associated with obtaining the contracts should be recognized in earnings as incurred and not deferred.

4.07 Other Assets and Liabilities

- 4.07(a) There are a variety of other assets and liabilities that may result from the acquisition of income producing property. Examples of other assets include prepaid expenses, such as taxes and insurance, 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, property management fees, interest, compensation, utilities and professional fees, and other liabilities, such as security deposits, unearned rental income, and fees payable in the ordinary course of operations.
- 4.07(b) 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 because of the short-term nature of these items, their undiscounted balances are considered to approximate their fair values.
- 4.07(c) Other assets or liabilities which are longer-term in nature (i.e., expected to be settled greater than one year from the date of the financial statements) should be reported at their fair value. These other assets and liabilities should be recorded in accordance with standards promulgated in SFAS 157. If there is an active market with quoted market prices for other

assets and liabilities held, this information should be used in determining fair value. In the absence of quoted market prices, fair values should be determined using a 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 rate used should reflect a current market rate commensurate with the risks of the specific asset (i.e., risk-free interest rate plus applicable credit spread, or the current market rates applicable to liabilities of similar duration or risk). SFAS 157 (paragraph A31) states, "The reporting Fund should consider the effect of its credit risk (credit standing) on the fair value of the liability because those who might hold the entity's obligations as assets would consider the effect of the entity's credit standing in determining the prices they would be willing to pay."

- 4.07(d) 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 the real property or the investment.
- 4.07(e) Changes in the fair value of other assets and liabilities from period to period are reported on the statement of operations 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.

4.08 Receivables

- 4.08(a) Various operating transactions may result in notes or accounts receivable. These receivables may be short-term or long-term in nature.
- 4.08(b) The undiscounted carrying value of short-term receivables (e.g., less than one year to maturity) generally approximates fair 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 uncollectible. Any such allowance is charged against net investment income; however, industry practice varies as to whether the allowance is charged against revenue or as an operating expense. Generally, allowances related to bad debts should be recorded 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.
- 4.08(c) The fair value of longer-term receivables should be estimated by discounting the expected future cash flows 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 uncollectible. Consideration should be given to any underlying collateral.

4.09 Other Liabilities

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 period in which the contingency is resolved.

4.10 Real Estate Revenues and Expenses

- 4.10(a) The ownership of income producing property encompasses real estate revenues directly associated with the underlying property or properties and may include the following: rental income, as well as funds receivable for the recovery of real estate expenses, percentage rent, and miscellaneous tenant charges. Real estate expenses may include utility costs, property management fees, real estate taxes, and normal maintenance expenses.
- 4.10(b) When reporting property specific information, or when utilizing such information under the Operating Reporting Model real estate revenues should be recorded when contractually earned. Rent concessions (such as free rent, stepped rent) should not be recorded as income until the rent payments are earned and billable. This process matches appraisal methodology which factors in the future rental income in the determination of the property value. 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).
- 4.10(c) 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.
- 4.10(d) Real estate expenses should be recognized when incurred. Companies should consider authoritative accounting literature such as EITF Issue No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*, for recording of revenues and expenses gross or net.

4.11 Realized and Unrealized Gains and Losses

- 4.11(a) The periodic valuation of real property, real estate investments, and funds and other non-current assets and liabilities, pursuant to the fair 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 disposition of the transaction or the settlement of liabilities; however, sales transactions must also meet the gain recognition criteria set forth in SFAS No. 66, *Accounting for Sales of Real Estate*. Gains that are deferred in accordance with SFAS No. 66 continue to be reported as unrealized.

- 4.11(b) 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 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.
- 4.11(c) 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 recorded as a receivable or payable.
- 4.11(d) 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.

REIS Guidance
REIS Fair Value Accounting Policy Manual
Appendices

Appendix 1:

Illustrative Financial Statements for Operating Reporting Model

The accompanying financial statements are illustrative only and are intended to provide an illustrative format for annual financial statement reporting under the fair value basis of accounting using the **Operating Reporting Model**. The illustrative statements reflect common financial statement presentation and disclosure items typically used in the institutional real estate investment community where the Operating Model is used. 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.

XYZ Real Estate Account

Financial Statements for the
Years Ended December 31, 20X8 and 20X7

XYZ REAL ESTATE ACCOUNT

CONSOLIDATED STATEMENTS OF NET ASSETS AS OF DECEMBER 31, 20X8 AND 20X7 (In thousands)

ASSETS

REAL ESTATE INVESTMENTS – At fair value:

Real estate and improvements (cost: December 31, 20x8 and 20x7 — \$xx,xxx and \$xx, xxx respectively)	\$	\$
Unconsolidated real estate joint ventures (cost plus equity in undistributed earnings: December 31, 20x8 and 20x7 — \$xx,xxx and \$xx,xxx respectively)		
Mortgage and other loans receivable (cost: December 31, 20x8 and 20x7 — \$xx,xxx and \$xx,xxx respectively)		
Other real estate investments (cost: December 31, 20x8 and 20x7 — \$xx,xxx and \$xx, xxx respectively)		
Total real estate investments	_____	_____

CASH AND CASH EQUIVALENTS

MARKETABLE SECURITIES

ACCRUED INVESTMENT INCOME (Net of allowance for doubtful accounts;
December 31, 20x8 and 20x7 — \$xx,xxx and \$xx,xxx respectively)

PREPAID AND OTHER ASSETS, Net	_____	_____
TOTAL ASSETS	<u>\$</u>	<u>\$</u>

LIABILITIES AND NET ASSETS

LIABILITIES:

Mortgage loans and notes payable — at fair value	\$	\$
Accrued real estate expenses and taxes		
Accrued incentive fees		
Other liabilities	_____	_____
Total liabilities		

COMMITMENTS AND CONTINGENCIES

NET ASSETS:

XYZ Real Estate Account net assets		
Noncontrolling interests	_____	_____
NET ASSETS	<u>\$</u>	<u>\$</u>

For illustrative purposes only - Operating Model Financial statements

XYZ REAL ESTATE ACCOUNT

CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 20X8 AND 20X7

INVESTMENT INCOME:		
Revenue from real estate	\$	\$
Equity in income of unconsolidated real estate joint ventures		
Interest and equity income on mortgage and other loans receivable		
Income from other real estate investments		
Other income		
	_____	_____
Total	_____	_____
EXPENSES:		
Real estate expenses and taxes		
Interest expense		
Administrative expenses		
Investment management fees		
	_____	_____
Total expenses	_____	_____
NET INVESTMENT INCOME		
NET REALIZED AND UNREALIZED GAIN (LOSS):		
Realized gain (loss) from sales		
Less: previously recorded unrealized (gain) loss on sales		
	_____	_____
Unrealized gain (loss) on investments held at year end		
Unrealized incentive fees		
	_____	_____
Net realized and unrealized gain (loss)	_____	_____
INCREASE (DECREASE) IN NET ASSETS RESULTING FROM OPERATIONS		
LESS: Portion attributable to noncontrolling interests		
	_____	_____
INCREASE IN NET ASSETS RESULTING FROM OPERATIONS ATTRIBUTABLE TO XYZ REAL ESTATE ACCOUNT	\$ _____	\$ _____
AMOUNTS ATTRIBUTABLE TO XYZ REAL ESTATE ACCOUNT		
Net investment income		
Net realized and unrealized gain (loss)		
	_____	_____
INCREASE IN NET ASSETS RESULTING FROM OPERATIONS ATTRIBUTABLE TO XYZ REAL ESTATE ACCOUNT	\$ _____	\$ _____

For illustrative purposes only - Operating Model Financial statements

XYZ REAL ESTATE ACCOUNT

CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS FOR THE YEARS ENDED DECEMBER 31, 20X8 AND 20X7

INCREASE (DECREASE) IN NET ASSETS RESULTING FROM OPERATIONS:

Net investment income	\$	\$
Net gain (loss) realized on real estate investments sold		
Net unrealized gain (loss) on real estate investments		
Less: portion attributable to noncontrolling interests		
	_____	_____
Increase (decrease) in net assets resulting from operations	_____	_____

INCREASE (DECREASE) IN NET ASSETS RESULTING FROM CAPITAL TRANSACTIONS:

Contributions		
Distributions		
Less: portion attributable to noncontrolling interests		
	_____	_____
Increase (decrease) in net assets resulting from capital transactions:	_____	_____

INCREASE (DECREASE) IN NET ASSETS

NET ASSETS — Beginning of year, as previously reported

CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE
(Note 2)

NET ASSETS — Beginning of year, as revised	_____	_____
NET ASSETS — End of year	\$ _____	\$ _____

For illustrative purposes only - Operating Model Financial statements

XYZ REAL ESTATE ACCOUNT

CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 20X8 AND 20X7

CASH FLOWS FROM OPERATING ACTIVITIES:

Net increase in net assets resulting from operations	\$	\$
Adjustments to reconcile net assets resulting from operations to net cash flows from operating activities:		
Net realized and unrealized (gains) loss		
Amortization		
Payment of financing costs		
Equity in income of unconsolidated real estate joint ventures		
Income distributions from unconsolidated real estate joint ventures		
Purchase of marketable securities		
Sales and maturities of marketable securities		
Changes in other assets and liabilities:		
Prepaid and other assets		
Accrued investment income		
Accrued real estate expenses and taxes		
Other liabilities		
	_____	_____
Net cash flow provided by (used in) operating activities	_____	_____

CASH FLOWS FROM INVESTING ACTIVITIES:

Capital distributions from unconsolidated real estate joint ventures		
Capital expenditures on real estate investments		
Investment in real estate joint ventures		
Payment of incentive fees		
Net proceeds from real estate investments sold		
Funding of mortgage and other loans receivable		
Principal payments on mortgage and other loans receivable		
Purchase of marketable securities		
Sales and maturities of marketable securities		
	_____	_____
Net cash flow provided by (used in) investing activities	_____	_____

CASH FLOWS FROM FINANCING ACTIVITIES:

Proceeds from mortgage loans payable		
Principal repayments on mortgage loans payable		
Payment of financing costs		
Distributions		
Capital contributions		
Contributions from noncontrolling interests		
Distributions to noncontrolling interests		
	_____	_____
Net cash flow provided by (used in) financing activities	_____	_____

NET CHANGE IN CASH AND CASH EQUIVALENTS

CASH AND CASH EQUIVALENTS — BEGINNING OF YEAR	_____	_____
CASH AND CASH EQUIVALENTS — END OF YEAR	\$ _____	\$ _____

SUPPLEMENTAL CASH FLOW INFORMATION:

Cash paid for interest, net of amounts capitalized of \$ ____	\$	\$
Cash paid for income taxes		

For illustrative purposes only - Operating Model financial statements
Adopting Release - REIS, Chapter 2

XYZ REAL ESTATE ACCOUNT

SCHEDULE OF INVESTMENTS* AS OF DECEMBER 31, 20X8 AND 20X7:

Property Name	Ownership	City, State	Square Feet Unless Otherwise Indicated (Unaudited)	December 31, 20x8		December 31, 20x7	
				Cost	Fair Value	Cost	Fair Value
REAL ESTATE OWNED AND JOINT VENTURES							
APARTMENT							
Apt 1	WO	City, State	xxx units	\$	\$	\$	\$
Apt 2	CJV	City, State	xxx units	_____	_____	_____	_____
APARTMENT TOTAL		x % as of 12/31/x8		_____	_____	_____	_____
HOTEL							
Hotel 1	CJV	City, State	xxx rooms	_____	_____	_____	_____
HOTEL TOTAL		x % as of 12/31/x8		_____	_____	_____	_____
INDUSTRIAL							
INDUSTRIAL 1	WO	City, State	xxx	_____	_____	_____	_____
INDUSTRIAL TOTAL		x % as of 12/31/x8		_____	_____	_____	_____
OTHER INVESTMENTS							
Other	EJV	City, State	N/A	_____	_____	_____	_____
OTHER INVESTMENTS TOTAL		x % as of 12/31/x8		_____	_____	_____	_____
OFFICE							
Office 1	EJV	City, State	xxx	_____	_____	_____	_____
OFFICE TOTAL		x % as of 12/31/x8		_____	_____	_____	_____
RETAIL							
RETAIL 1	CJV	City, State	xxx	_____	_____	_____	_____
RETAIL TOTAL		x % as of 12/31/x8		_____	_____	_____	_____
TOTAL REAL ESTATE OWNED AND JOINT VENTURES				_____	_____	_____	_____
MORTGAGE AND OTHER LOANS RECEIVABLE							
LOAN 1	Loan		N/A	_____	_____	_____	_____
LOAN 2	Eloan	City, State	xxx	_____	_____	_____	_____
MORTGAGE AND OTHER LOANS RECEIVABLE TOTAL		x % as of 12/31/x8		_____	_____	_____	_____
OTHER REAL ESTATE INVESTMENTS							
OTHER	NR	City, State	N/A	_____	_____	_____	_____
OTHER REAL ESTATE INVESTMENTS TOTAL		x % as of 12/31/x8		_____	_____	_____	_____
TOTAL REAL ESTATE INVESTMENTS				<u>\$</u>	<u>\$</u>	<u>\$</u>	<u>\$</u>

WO - Wholly Owned Investment

CJV - Consolidated Joint Venture

EJV - Joint Venture Investment accounted for under the equity method

Eloan - Mezzanine loan accounted for under the equity method

NR - Note Receivable

** REQUIRED INFORMATION - AT MINIMUM ALL INVESTMENTS GREATER THAN 5% OF NET ASSETS MUST BE SEPARATELY IDENTIFIED AS AN INVESTMENT. BALANCE CAN BE LISTED AS OTHER WITHIN EACH SEGMENT. RECOMMENDED INFORMATION - THE GREATER OF YOUR TWENTY LARGEST INVESTMENTS OR YOUR 5% INVESTMENTS.*

See accompanying notes to the consolidated financial statements.

XYZ REAL ESTATE ACCOUNT

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 20X8 AND 20X7

1. ORGANIZATION

The XXXX Retirement Association has approved certain asset allocations in core equity real estate (the “Account”) for which Real Estate Account LLC is the Investment Advisor (“ABC” or “Investment Advisor”). The Account is an investment account in the business of acquiring, improving, operating, and holding for investment, income-producing industrial, office, and residential properties.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation — The accompanying consolidated financial statements of the Account have been presented in conformity with accounting principles generally accepted in the United States of America. The consolidated financial statements of the Account include the accounts of its wholly-owned and controlled subsidiaries. All intercompany transactions are eliminated in the consolidation.

Use of Estimates — The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates.

The real estate and capital markets are cyclical in nature. Property and investment values are affected by, among other things, the availability of capital, occupancy rates, rental rates and interest and inflation rates. As a result, determining real estate and investment values involves many assumptions. Amounts ultimately realized from each investment may vary significantly from the fair values presented.

Investments in Properties — Investments in properties are carried at fair value. Properties owned are initially recorded at the purchase price plus closing costs. Development costs and major renovations are capitalized as a component of cost, and routine maintenance and repairs are charged to expense as incurred. Real estate costs include the cost of acquired property, including all tangible and intangible assets. Tangible assets include the value of all land, building and tenant improvements at the time of acquisition. Intangible assets include the value of any above and below market leases, in-place leases, and tenant relationships at the time of acquisition.

Investments in Joint Ventures — Investments in joint ventures are carried at fair value and are presented in the financial statements using the equity method of accounting since control of the investment is shared with the respective venture member. Under the equity method, the

investment is initially recorded at the original investment amount, plus additional amounts invested, and is subsequently adjusted for the Account's share of undistributed earnings or losses (including unrealized appreciation and depreciation) from the underlying entity. In addition, the Account classifies and accounts for investments in certain participating loans as investments in joint ventures where arrangements have virtually the same risks and rewards of ownership.

Investments in Mortgage Loans and Notes Receivable — Investments in mortgage loans receivable are carried at fair value. Loan acquisition and origination costs are capitalized as a component of cost.

Investment Valuation — Real estate values are based upon independent appraisals, estimated sales proceeds or the Advisor's opinion of value. Such values have been identified for investment and portfolio management purposes only; the Account reserves its right to pursue full remedies for the recovery of its investments and other rights. The fair value of real estate investments does not reflect transaction sale costs, which may be incurred upon disposition of the real estate investments.

As described above, the estimated fair value of real estate related assets is determined through an appraisal process. These estimated fair values may vary significantly from the prices at which the real estate investments would sell, since market prices of real estate investments can only be determined by negotiation between a willing buyer and seller. Although the estimated fair values represent subjective estimates, management believes these estimated fair values are reasonable approximations of market prices and the aggregate estimated value of investments in real estate is fairly presented at December 31, 20x8 and 20x7.

Concentration of Credit Risk — The Account invests its cash primarily in deposits and money market funds with commercial banks. At times, cash balances at a limited number of banks and financial institutions may exceed federally insured amounts. The general partner believes it mitigates credit risk by depositing cash in or investing through major financial institutions. In addition, in the normal course of business, the Account extends credit to its tenants, which consist of local, regional and national based tenants. The general partner does not believe this represents a material risk of loss with respect to its financial position.

Cash and Cash Equivalents — Cash and cash equivalents are comprised of cash and short-term investments with original maturity dates of less than ninety days from the date of purchase.

Mortgage Loans and Notes Payable — Mortgage loans and notes payable are shown at fair value. Deferred financing costs represent costs incurred in connection with the mortgage loans and notes payable of the Account and its wholly owned subsidiaries. For the year ended December 31, 20x7, such costs amounted to \$_____ net of accumulated amortization of \$xxx. Subsequent to the adoption of SFAS 159, deferred financing costs are charged to expense as incurred and not deferred. For the year ended December 31, 20x8 the Account incurred financing

costs of \$xx,xxx. Such amounts are included in interest expense in the accompanying statement of operations.

Interest Rate Swaps and Caps — The Account records derivative financial instruments, primarily interest rate caps and swaps, at fair value, which is the estimated amounts that the Account would receive or pay in a current exchange transaction at the reporting date, taking into account current interest rates and the current credit worthiness of the respective counter-parties. The Account uses interest rate swaps and caps in order to reduce the effect of interest rate fluctuations of certain real estate investments' interest expense on variable debt. See Note 6.

Revenue and Expense Recognition — Rental income is recognized on an accrual basis in accordance with the terms of the underlying lease agreements. Interest income is accrued as earned in accordance with the contractual terms of the loan agreements. Operating expenses are recognized as incurred.

Investment Advisory Fees — Investment advisory fees include asset management fees and investment acquisition fees charged by ABC. Such amounts are reflected in the accompanying financial statements when incurred.

Income Taxes — The Account has been classified as a qualified trust under Section 401(a) of the internal Revenue code of 1986 (the "Code") and management believes it continues to comply with the requirements of Section 501(a) of the code. Accordingly, the Account is exempt from income taxes, and no income tax provision is provided.

Guarantees — The Account is required to recognize, at inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing a guarantee. At the inception of guarantees issued, the Account will record the fair value of the guarantee as a liability, with the offsetting entry being recorded based on the circumstances in which the guarantee was issued. The Account did not have any material guarantee liabilities at December 31, 20X8 and 20x7..

Foreign Currency — For investments held outside the United States of America (the "USA"), the Account uses the local currency of the place of operations as its functional currency. Assets and liabilities are translated to U.S. dollars using current exchange rates at the balance sheet date. Revenue and expenses are translated to U.S. dollars using a weighted average exchange rate during the year. The gains and losses resulting from such translation are reported as a component of unrealized gains and losses on the statement of operations. The cumulative translation gain (loss) as of December 31, 20x8 and 20x7 was \$_____ and \$_____, respectively. Foreign currency transactions may produce receivables or payables that are fixed in terms of the amount of foreign currency that will be received or paid. A change in the exchange rates between the functional currency and the currency in which the transaction is denominated increases or decreases the expected amount of functional currency cash flows upon settlement of that transaction. That increase or decrease in the expected functional currency cash flows is a foreign currency transaction gain or loss that generally will be included in determining total unrealized

gains and losses on the statement of operations. A transaction gain or loss (measured from the transaction date or the most recent intervening balance sheet date, whichever is later), realized upon settlement of a foreign currency transaction generally will be included as a component of realized gains and losses on the statement of operations. The real estate investments were funded partially through financing based arrangements that are scheduled for settlement, consisting primarily of accrued interest and intercompany loans with scheduled principal payments. For the years ended December 31, 20x8 and 20x7, the Account recognized realized gains of \$_____ and \$_____, respectively on foreign currency transactions in connection with the distribution of cash from foreign operating investees to the Account.

Risk Management — In the normal course of business, the Account encounters economic risk, including interest rate risk, credit risk, foreign currency risk and market risk. Interest rate risk is the result of movements in the underlying variable component of the mortgage financing rates. Credit risk is the risk of default on the Account’s real estate investments that results from an underlying tenant’s inability or unwillingness to make contractually required payments. Foreign currency risk is the effect of exchange rate movements of foreign currencies against the dollar. Market risk reflects changes in the valuation of real estate investments held by the Account.

The Account has not directly entered into any derivative contracts for speculative or hedging purposes against these risks. One of the Account’s investments (_____), which owns a facility in _____, has entered into a pay-fixed interest rate swap to manage interest rate risk exposure on its variable rate financing. The investee (_____) is potentially exposed to credit loss in the event of non-performance by the counterparty; however, due to the counterparty’s credit rating, the Account does not anticipate that the counterparty will fail to meet their obligations.

Changes in Accounting Principle — In 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards 157, Fair Value Measurements (“SFAS 157”). SFAS 157 provides guidance for using fair value or measure assets and liabilities. SFAS 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. SFAS 157 includes provisions that require expanded disclosure of the effect on earnings for items measured using unobservable data. The Account adopted SFAS 157 effective January 1, 20x8.

In 2007, the FASB issued Statement of Financial Accounting Standards 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 (“SFAS 159”), which permits entities to choose to measure many financial instruments and certain other items at fair value (“Fair Value Option”). Election of the Fair Value Option is made on an instrument-by-instrument basis and is irrevocable. The Account elected the Fair Value Option effective January 1, 20x8. At the adoption date, unrealized gains and losses on financial assets and liabilities for which the Fair Value Option has been elected are reported as a cumulative adjustment to beginning retained earnings. The Account made the election to record its debt at fair value because it believes it is a better representation of the asset

value. The Account will report unrealized gains and losses due to changes in fair value in earnings at each subsequent reporting date.

In December 2007, the FASB issued Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements – an amendment to ARB No. 51 (Statement 160). Statement 160 requires noncontrolling interests (previously referred to as minority interests) to be reported as a component of equity, which changes the accounting for transactions with noncontrolling interest holders. (For purposes of this illustration, assume the Statement is effective as of January 1, 20x8). Statement 160 is applied prospectively to all noncontrolling interests, except the presentation and disclosure requirements. The presentation and disclosure requirements were applied retrospectively for all periods presented, as follows: (i) the noncontrolling interest was reclassified to equity, and (ii) consolidated net income was adjusted to include the net income attributed to the noncontrolling interest.

Impact of Accounting Standards Not Yet Adopted — [to be tailored to each year]

3. FAIR VALUE MEASUREMENTS

In determining fair value, the Account uses various valuation approaches. SFAS 157 establishes fair value measurement framework, provides a single definition of fair value, and requires expanded disclosure summarizing fair value measurements. SFAS 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing an asset or liability.

The statement establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable input be used when available. Observable inputs are inputs that the market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Account. Unobservable inputs are inputs that reflect the Account's assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is measured in three levels based on the reliability of inputs:

Level 1— Valuations based on quoted prices in active markets for identical assets or liabilities that the Account has the ability to access. Valuation adjustment and block discounts are not applied to Level 1 instruments.

Level 2 — Valuations based on quoted prices in less active, dealer or broker markets. Fair values are primarily obtained from third party pricing services for identical or comparable assets or liabilities.

Level 3 — Valuations derived from other valuation methodologies, including pricing models, discounted cash flow models and similar techniques, and not based on market, exchange, dealer,

or broker-traded transactions. Level 3 valuations incorporate certain assumptions and projections that are not observable in the market and significant professional judgment in determining the fair value assigned to such assets or liabilities.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

The following is a description of the valuation techniques used for investments measured at fair value:

Real Estate Properties — The values of real estate properties have been prepared giving consideration to the income, cost and sales comparison approaches of estimating property value. The income approach estimates an income stream for a property (typically 10 years) and discounts this income plus a reversion (presumed sale) into a present value at a risk adjusted rate. Yield rates and growth assumptions utilized in this approach are derived from market transactions as well as other financial and industry data. The cost approach estimates the replacement cost of the building less physical depreciation plus the land value. Generally, this approach provides a check on the value derived using the income approach. The sales comparison approach compares recent transactions to the appraised property. Adjustments are made for dissimilarities which typically provide a range of value. Generally, the income approach carries the most weight in the value reconciliation.

Investment values are determined quarterly from limited restricted appraisals, in accordance with the Uniform Standards of Professional Appraisal Practice (“USPAP”), which include less documentation but nevertheless meet the minimum requirements of the Appraisal Standards Board and the Appraisal Foundation and are considered appraisals. In these appraisals, a full discounted cash flow analysis, which is the basis of an income approach, is the primary focus. Interim monthly valuations are determined by giving consideration to material investment transactions. Full appraisal reports are prepared on a rotating basis for all properties, so each property receives a full appraisal report at least once every three years.

Since appraisals take into consideration the estimated effect of physical depreciation, historical cost depreciation and amortization on real estate related assets has been excluded from net investment income.

The values of real estate properties undergoing development have been prepared giving consideration to costs incurred to date and to key development risk factors, including entitlement risk, construction risk, leasing/sales risk, operation expense risk, credit risk, capital market risk, pricing risk, event risk and valuation risk. The fair value of properties undergoing development includes the timely recognition of estimated entrepreneurial profit after such consideration.

During 20x8 and 20x7, all appraisals for the Account were prepared by independent external appraisers. The external appraisals are reviewed by an external appraisal management firm. All appraisal reports and appraisal reviews comply with the currently published USPAP, as promulgated by the Appraisal Foundation. The Account's real estate properties are generally classified within level 3 of the valuation hierarchy.

Real Estate Joint Ventures and Limited Accounts — Real estate joint ventures and certain limited Accounts are stated at the fair value of the Account's ownership interests of the underlying entities. The Account's ownership interests are valued based on the fair value of the underlying real estate, any related mortgage loans payable, and other factors, such as ownership percentage, ownership rights, buy/sell agreements, distribution provisions and capital call obligations. Upon the disposition of all real estate investments by an investee entity, the Account will continue to state its equity in the remaining net assets of the investee entity during the wind down period, if any that occurs prior to the dissolution of the investee entity. The Account's real estate joint ventures and limited Accounts are generally classified within level 3 of the valuation hierarchy.

Marketable Securities — Equity securities listed or traded on any national market or exchange are valued at the last sale prices as of the close of the principal securities exchange on which such securities are traded or, if there is no sale, at the mean of the last bid and asked prices on such exchange, exclusive of transaction costs. Such marketable securities are classified within level 1 of the valuation hierarchy.

Debt securities, other than money market instruments, are generally valued at the most recent bid price of the equivalent quoted yield for such securities (or those of comparable maturity, quality, and type). Money market instruments with maturities of one year or less, are valued in the same manner as debt securities or derived from a pricing matrix. Debt securities are generally classified within level 2 of the valuation hierarchy.

Mortgage Loans and Notes Receivable — The fair value of mortgage loans and notes receivable held by the Account have been determined by one or more of the following criteria as appropriate: (i) on the basis of estimated market interest rates for loans of comparable quality and maturity, (ii) by recognizing the value of equity participations and options to enter into equity participations contained in certain loan instruments and (iii) giving consideration to the value of the underlying collateral. The Account's mortgage loans and notes receivable is classified within level 3 of the valuation hierarchy.

Mortgage Loans and Notes Payable — The fair values of mortgage loans and notes payable are determined by discounting the future contractual cash flows to the present value using a current market interest rate. The market rate is determined by giving consideration to one or more of the following criteria as appropriate: (i) interest rates for loans of comparable quality and maturity, and (ii) the value of the underlying collateral. The Account's mortgage loans and notes payable are generally classified within level 3 of the valuation hierarchy.

The following are the major categories of assets and liabilities measured at fair value on a recurring basis during the year ended December 31, 20X8, using unadjusted quoted prices in active markets for identical assets (Level 1); significant other observable inputs (Level 2); and significant unobservable inputs (Level 3):

Description	Level 1: Quoted Prices in Active Markets for Identical Assets	Level 2: Significant Other Observable Inputs	Level 3: Significant Unobservable Inputs	Total at December 31, 20X8
Real estate properties	\$	\$	\$	\$
Real estate joint ventures and limited partnerships				
Marketable securities — real estate related				
Marketable securities — debt securities				
Mortgage loans and notes receivable	_____	_____	_____	_____
Total investments	\$ _____	\$ _____	\$ _____	\$ _____
Mortgage loans and notes payable	\$ _____	\$ _____	\$ _____	\$ _____

The following is a reconciliation of the beginning and ending balances for assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the year ended December 31, 20X8:

	Real Estate Properties	Real Estate Joint Ventures and Limited Partnerships	Mortgage Loan and Notes Receivable	Total Level 3 Investments	Mortgage Loans Payable
Beginning balance — January 1, 20X8	\$	\$	\$	\$	\$
Total realized and unrealized gains (losses) included in changes in net assets					
Purchases, issuances, and settlements	_____	_____	_____	_____	_____
Ending balance — December 31, 20X8	\$ _____	\$ _____	\$ _____	\$ _____	\$ _____

4. REAL ESTATE

The following is a summary of the fair value basis assets, liabilities, and operating results underlying the Account’s joint venture investments at December 31, 20x8 and 20x7, and for the years then ended:

	12/31/X8	12/31/X7
Land and buildings	\$	\$
Other assets		
Mortgage loans		
Other liabilities	_____	_____
Net assets	<u>\$</u>	<u>\$</u>
Account's share of real estate joint venture net assets	<u>\$</u>	<u>\$</u>
Year Ended	12/31/X8	12/31/X7
Revenues	\$	\$
Property operating expenses		
Interest expense	_____	_____
Net investment income	<u>\$</u>	<u>\$</u>
Account's equity in income of real estate joint ventures	<u>\$</u>	<u>\$</u>

5. MORTGAGE LOANS AND NOTES PAYABLE

Mortgage loans and notes payable consist of the following as of December 31, 20x8 and 20x7:

	20x8 Loan Balance at Fair Value	20x8 Principal Balance Outstanding	20x7 100% Loan Balance at Fair Value	Interest Rate ¹	Maturity Date	Terms ⁵
Mortgages on Wholly Owned Properties and Consolidated Partnerships						
Property Name	\$	\$	\$	x.xx%	2011	P&I, PP
Property Name				LIBOR (30-day) + x.xx%	2015	I
Property Name				LIBOR (30-day) + x.xx%	2015	I
Property Name				LIBOR (30-day) + x.xx%	2015	I
Property Name				LIBOR (30-day) + x.xx%	2015	I
Property Name	_____	_____	_____	LIBOR (30-day) + x.xx%	2017	I
Total Mortgage Loans Payable						

¹ As of December 31, 20x8, 30 day LIBOR was x.xxxx%.

² Represents the Account’s interest in the loan based upon the estimated percentage of net assets which would be distributed to the Account if the Accounts were liquidated at December 31, 20x8. It does not represent the Account’s legal obligation.

³ This is an average rate calculated on staggering tranches at LIBOR + x.xx%.

⁴ The loan has a floating interest rate of x.xx% over LIBOR however the venture is obligated to pay a fixed rate of x.xx% with the venture partner assuming all interest rate risk or benefit.

⁵ Loan Terms PP=Prepayment penalties applicable to loan, I=Interest only, P&I=Principal and Interest

⁶ The Account's weighted average interest rate for the year ending December 31, 20x8 was x.xx%. The weighted average interest rate was calculated using the Account's annualized interest expense for each loan (derived using the same percentage as that in (**)) above), divided by the Account's derived share of total debt.

⁷ The Weekly Variable Rate shall be the minimum rate of interest necessary, in the professional judgment of the Remarketing Agent, taking into consideration prevailing market conditions, to enable the Remarketing Agent to remarket all of the Bonds on the applicable Rate Determination Date at par plus accrued interest on the bonds for that week.

Mortgage loans payable for wholly owned properties and consolidated Accounts are collateralized by real estate investments with an aggregate estimated value of \$xxx,xxx as of December 31, 20x8. The loans agreements contain financial and non-financial covenants, including requirements regarding net assets, leverage ratio, and debt service coverage ratio. The Account believes it was in compliance with all covenants as of and for the year ended December 31, 20x8.

As of December 31, 20x8, principal amounts of mortgage loans payable and notes payable on wholly owned properties and consolidated Accounts are payable as follows:

Year Ended December 31

20x9	\$
20x0	
20x1	
20x2	
20x3	
Thereafter	_____
Total	\$ _____

The mortgage loans and notes may be prepaid, in whole or in part, at any time without premium or penalty.

6. INTEREST RATE SWAPS AND CAPS

Certain of Account's equity method and consolidated joint ventures entered into interest rate swap and cap transactions ("Swaps and Caps") with unrelated major financial institutions.

The Account has recorded the fair values of the Swaps and Caps as of December 31, 20x8 and 20x7, which have been reflected in "Unconsolidated Real Estate joint ventures" for equity joint ventures and "Other liabilities" for consolidated ventures on the Consolidated Statements of Net Assets. The resulting unrealized gain (loss) on the equity Accounts is reflected in the Consolidated Statements of Operations in "Change in unrealized gain (loss) on real estate investments". The resulting unrealized gain (loss) for consolidated ventures is reflected in the Consolidated Statements of Operations in "Change in unrealized gain (loss) on interest rate swaps and caps" and "Portion attributable to noncontrolling interests".

As of December 31, 20x8, Interest Rate Swaps and Caps are summarized as follows:

**Consolidated Joint Ventures
and Wholly Owned:**

Property 1	Pay — Fixed Swap	\$	x.xx%	\$	\$	\$	
Property 2	Pay — Floating						
	Swap		x.xx%				July 20x8
Property 3	Cap	_____		_____	_____	_____	July 20x6
Total Consolidated Joint Ventures		_____		_____	_____	_____	

Equity Joint Ventures:

Property 1	Pay — Fixed Swap		x.xx%				January 20x6
Property 2	Pay — Fixed Swap		x.xx%				March 20x0
Property 3	Pay — Fixed Swap		x.xx%				February 20x2
Property 4	Cap	_____		_____	_____	_____	April 20x9
Total Equity Joint Ventures		_____		_____	_____	_____	
Total		\$		\$	\$	\$	

7. PORTFOLIO DIVERSIFICATION

At December 31, 20x8, the Account had real estate investments located throughout the United States of America. The diversification of the account's holdings based on the estimated fair values and established NCREIF regions is as follows:

Region	Net Asset Value	Region %
East North Central	\$	64 %
Mideast		18 %
Mountain		18 %
Northeast		9 %
Pacific		9 %
Southeast		9 %
Southwest	_____	9 %
Total	\$	100 %

8. INVESTMENT ADVISOR FEES

Investment advisory fees for investments under management by ABC are billed at a rate of 15.0 basis points per quarter for the first \$200 million of gross asset value, 13.5 basis points per quarter for the next \$300 million of gross asset value, and 12.0 basis points per quarter thereafter, in arrears. ABC also earns acquisition fees equal to 75 basis points on acquisition costs.

For the years ended December 31, 20x8 and 20x7 total management fees earned by ABC totaled \$1,250 and \$1,000, respectively. Management fees of \$350 were unpaid as of December 31, 20x8.

9. LEASING

At December 31, 20x8, minimum future rental payments to be received under non-cancelable operating leases having a term of more than one year are as follows:

Year Ending December 31	Properties	Joint Ventures
20x9	\$	\$
20x0		
20x1		
20x2		
20x3		
Thereafter	_____	_____
TOTAL	\$ _____	\$ _____

The above future minimum base rentals exclude residential lease agreements with terms of less than one year, which accounted for approximately xx% of the Account's annual rental income for the years ended December 31, 20x8. Rental income for the years ended December 31, 20x8 and 20x7 included approximately \$xxx,xxx and \$xxx,xxx, respectively, recovered from tenants for common area expenses, other reimbursable costs, and percentage rents.

10. FINANCIAL HIGHLIGHTS (UNITIZED) – EXAMPLE 1

	<u>For the Year Ended December 31,</u>	
	<u>20x8</u>	<u>20x7</u>
PER SHARE (UNIT) OPERATING PERFORMANCE(*):		
Net Asset Value, beginning of period	\$	\$
INCOME FROM INVESTMENT OPERATIONS:		
Investment income, before management fees		
Net realized and unrealized gain (loss) on investments	_____	_____
Total from investment operations, before management fees		
Management fees	_____	_____
Total from investment operations		
Deemed contributions and cancellation of units for management fees	_____	_____
Net Asset Value, end of period	<u>\$</u>	<u>\$</u>
Total Return, before Management Fees (a):	x.xx%	x.xx%
Total Return, after Management Fees (a):	x.xx%	x.xx%
RATIOS/SUPPLEMENTAL DATA:		
Ratios to average net assets (b):		
Total Expenses	x.xx%	x.xx%
Net Investment Income	x.xx%	x.xx%

(*) All amounts are shown net of amounts allocated to noncontrolling interests

(a) Total Return, before/ after management fees is calculated by geometrically linking quarterly returns which are calculated using the formula below:

Investment Income before/after Management Fees + Net Realized and Unrealized Gains/Losses

Beg. Net Asset Value + Time Weighted Contributions - Time Weighted Distributions

(b) (b) Average net assets are based on beginning of quarter net assets.

10. FINANCIAL HIGHLIGHTS (CLOSED END/ FINITE LIVED) – EXAMPLE 2

	For the Year Ended December 31, 20X8
Total Return:	
Internal Rate of Return (a)	x.xx%
Ratios/Supplemental Data:	
Net Assets, end of period	\$ _____
Ratios to average net assets (b):	
Total investment expenses	
Incentive Allocation	x.xx%
Total Expenses and incentive allocation	x.xx%
Net Investment Income	x.xx%
Ratio of total contributed capital to committed capital	x.xx%

(*) All amounts are shown net of amounts allocated to noncontrolling interests

(a) Total return is calculated based on a dollar-weighted internal rate of return methodology net of fees and incentive allocations. Internal rate of return is computed on a cumulative, since inception basis using annual compounding and the actual dates of cash inflows received by and outflows paid to limited partners and including ending net asset value as of each measurement date.

(b) Average net assets are calculated based on an average of beginning quarterly net assets.

A table presenting the required disclosures for the year ended December 31, 20x7 is not presented. The presentation of these ratios and returns is not meaningful, since no capital was contributed during 20x7. ratios to average net assets and internal rate of return are calculated for the limited partners as a whole. The computation of such ratios and returns for an individual partner may vary from these ratios and returns based on different management fee and incentive arrangements. The net investment income ratio does not reflect the effects of any incentive allocation.

11. COMMITMENTS AND CONTINGENCIES

In November 2002, the Financial Accounting Standards Board issued Interpretation No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others” (“FIN 45”). FIN 45 specifies the accounting for and disclosures to be made regarding obligations under certain guarantees.

The Account may issue loan guarantees to obtain financing agreements and/or preferred terms related to its investments. These guarantees include mortgage and construction loans and may cover payments of principal and/or interest. These guarantees have fixed termination dates and become liabilities of the Account in the event the borrower is unable to meet the obligations

specified in the guarantee agreement. The Account may also be liable under certain of these guarantees in the event of fraud, misappropriation, environmental liabilities, and certain other matters involving the borrower.

The Account is a guarantor of the following outstanding recourse obligations:

Real Estate Investment	Expiration Date	Maximum Obligation	Fair Value of Guarantee Liability (a)
		\$	\$

- (a) The fair value of guarantees are included in other liabilities on the balance sheet with a corresponding adjustment to the cost basis of the related investment.

In the normal course of business, the Account enters into other contracts that contain a variety of representations and warranties and which provide general indemnifications. The Account's maximum exposure under these arrangements is unknown, as this would involve future claims that may be made against the Account that have not yet occurred. However, based on experience, management expects the risk of loss to be remote.

As of December 31, 20x8, the Account had the following outstanding commitments to purchase real estate or fund additional expenditures on previously acquired properties, which are expected to be funded in 20x5:

Property Type	Commitment
Apartment	\$
Retail	
Office	
Industrial	
Loan	_____
Total	\$ _____

Certain purchases of real estate are contingent on a developer building the real estate according to plans and specifications outlined in the pre-sale agreement and other conditions precedent. It is anticipated that funding will be provided by operating cash flow, real estate sales, deposits from clients and Account's line of credit.

The Account purchased various real estate during 20x8 that include earn-out provisions. An amount of \$xxx,xxx has been accrued as of December 31, 20x8 and is included in Accrued Real Estate Expenses and Taxes on the Consolidated Statements of Assets and Liabilities.

There were various legal actions relating to the properties in the Account in the ordinary course of business. In the opinion of the Account's management, the outcome of such matters will not have a material effect on the Account's financial condition or results of operations.

12. SUBSEQUENT EVENT

Subsequent to year end, on January 15, 20x9, the Account purchased a 115,000 square foot office property in Washington D.C. for \$xxx,xxx.

* * * * *

Appendix 2:

Illustrative Financial Statements for Non-Operating Reporting Model

The accompanying financial statements are illustrative only and are intended to provide an illustrative format for annual financial statement reporting under the fair value basis of accounting using the **Non-Operating Reporting Model**. The illustrative statements reflect common financial statement presentation and disclosure items typically used in the institutional real estate investment community where the Non-Operating Reporting Model is used. 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.

XYZ Real Estate Fund, LP

Financial Statements for the Years
Ended December 31, 20X8 and 20X7

XYZ REAL ESTATE FUND LP

STATEMENT OF ASSETS AND LIABILITIES AS OF DECEMBER 31, 20X8 AND 20X7 (Dollars in Thousands)

	20x8	20x7
ASSETS:		
Real estate investments	\$	\$
Cash and cash equivalents		
Other assets	_____	_____
TOTAL	\$ =====	\$ =====
LIABILITIES:		
Mortgage loans and notes payable	\$	\$
Other liabilities		
Total liabilities	_____	_____
NET ASSETS	\$ =====	\$ =====

For illustrative purposes only – Non-operating reporting model financial statements

XYZ REAL ESTATE FUND LP

STATEMENT OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 20X8 AND 20X7 (Dollars in Thousands)

	20X8	20X7
INCOME:		
Income distributions from real estate equity investments	\$	\$
Interest income on real estate debt investments		
Other	_____	_____
Total income		
EXPENSES		
Interest expense		
Administrative expenses		
Investment management fees	_____	_____
Total expenses	_____	_____
NET INVESTMENT INCOME	_____	_____
NET REALIZED AND UNREALIZED GAIN (LOSS):		
Realized gain (loss) from sales		
Less: Previously recorded unrealized (gain) loss on sales	_____	_____
Net realized gain (loss)		
Unrealized gain (loss) on investments held at year end		
Unrealized incentive fees	_____	_____
Net unrealized gain (loss)	_____	_____
Net realized and unrealized gain (loss)	_____	_____
NET INCREASE (DECREASE) IN NET ASSETS RESULTING FROM OPERATIONS	\$ _____	\$ _____

For illustrative purposes only – Non-operating reporting model financial statements

XYZ REAL ESTATE FUND LP

STATEMENT OF CHANGES IN NET ASSETS FOR THE YEARS ENDED DECEMBER 31, 20X8 AND 20X7 (Dollars in Thousands)

	General Partner	Limited Partners	Total
NET ASSETS — December 31, 20X6	\$	\$	\$
Increase in net assets from operations			
Capital contributions			
Income distributions			
Return of capital distributions			
NET ASSETS — December 31, 20X7, as previously reported	_____	_____	_____
Cumulative effect of change in accounting principle (Note 2)			
NET ASSETS — December 31, 20X7, as revised	_____	_____	_____
Increase in net assets from operations			
Capital contributions			
Income distributions			
Return of capital distributions			
NET ASSETS — December 31, 20X8	<u>\$</u>	<u>\$</u>	<u>\$</u>

For illustrative purposes only – Non-operating reporting model financial statements

XYZ REAL ESTATE FUND LP

STATEMENT OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 20X8 AND 20X7 (Dollars in Thousands)

	20X8	20X7
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net increase in net assets resulting from operations	\$	\$
Adjustments to reconcile net assets resulting from operations to net cash flows provided by operating activities:		
Net realized and unrealized (gain) loss		
(Increase) / decrease in other assets		
Increase / (decrease) in other liabilities		
Capital distributions from real estate investments		
Funding of real estate investments		
Proceeds from real estate investments sold	_____	_____
Net cash flow provided by operating activities	_____	_____
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from mortgage loans payable		
Principal repayments on mortgage loans payable		
Distributions		
Capital contributions	_____	_____
Net cash flow used in financing activities	_____	_____
Net change in cash and cash equivalents		
CASH AND CASH EQUIVALENTS — Beginning of year	_____	_____
CASH AND CASH EQUIVALENTS — End of year	_____	_____
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash paid for interest on mortgage loans	\$ _____	\$ _____
Cash paid for income taxes	\$ _____	\$ _____

For illustrative purposes only – Non-operating reporting model financial statements

XYZ REAL ESTATE (ACCOUNT / FUND LP)

SCHEDULE OF INVESTMENTS* FOR THE YEARS ENDED DECEMBER 31, 20X8 AND 20X7

Property Name	City, State	Square Feet Unless Otherwise Indicated (Unaudited)	December 31, 20x8		December 31, 20x7	
			Cost	Fair Value	Cost	Fair Value
REAL ESTATE EQUITY INVESTMENTS						
APARTMENT						
Apt 1	City, State	xxx units	\$	\$	\$	\$
Apt 2	City, State	xxx units	_____	_____	_____	_____
APARTMENT TOTAL	x % as of 12/31/x8		_____	_____	_____	_____
HOTEL						
Hotel 1	City, State	xxx rooms	_____	_____	_____	_____
HOTEL TOTAL	x % as of 12/31/x8		_____	_____	_____	_____
INDUSTRIAL						
INDUSTRIAL 1	City, State	xxx	_____	_____	_____	_____
INDUSTRIAL TOTAL	x % as of 12/31/x4		_____	_____	_____	_____
OTHER INVESTMENTS						
Other	City, State	N/A	_____	_____	_____	_____
OTHER INVESTMENTS TOTAL	x % as of 12/31/x8		_____	_____	_____	_____
OFFICE						
Office 1	City, State	xxx	_____	_____	_____	_____
OFFICE TOTAL	x % as of 12/31/x8		_____	_____	_____	_____
RETAIL						
RETAIL 1	City, State	xxx	_____	_____	_____	_____
RETAIL TOTAL	x % as of 12/31/x8		_____	_____	_____	_____
TOTAL REAL ESTATE OWNED						
MORTGAGE AND OTHER LOANS RECEIVABLE						
LOAN 1		N/A	_____	_____	_____	_____
LOAN 2	City, State	xxx	_____	_____	_____	_____
MORTGAGE AND OTHER LOANS RECEIVABLE TOTAL	x % as of 12/31/x8		_____	_____	_____	_____
OTHER REAL ESTATE INVESTMENTS						
OTHER	City, State	N/A	_____	_____	_____	_____
OTHER REAL ESTATE INVESTMENTS TOTAL	x % as of 12/31/x8		_____	_____	_____	_____
TOTAL REAL ESTATE INVESTMENTS			\$	\$	\$	\$

* *REQUIRED INFORMATION - AT MINIMUM ALL INVESTMENTS GREATER THAN 5% OF NET ASSETS MUST BE SEPARATELY IDENTIFIED AS AN INVESTMENT. BALANCE CAN BE LISTED AS OTHER WITHIN EACH SEGMENT. RECOMMENDED INFORMATION - THE GREATER OF YOUR TWENTY LARGEST INVESTMENTS OR YOUR 5% INVESTMENTS.*

For illustrative purposes only – Non-operating reporting model financial statements

XYZ REAL ESTATE FUND LP

NOTES TO FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 20X8 AND 20X7

13. ORGANIZATION

XYZ Real Estate Fund LP (the “Fund”) was formed on January 1, 19x1 for the purpose of generating income and appreciation on real estate investments in the United States of America. The investment advisor of the Fund is ABC Real Estate Advisors, L.P. (“ABC” or the “Advisor”). The aggregate committed capital for the Fund is \$200 million. The limited partners committed \$190 million and the general partner committed \$10 million. The terms of the partnership agreement do not generally provide for new subscription or redemption of partners’ interests. The general partner of the Fund is ABC, L.P., an affiliate of the Advisor. At December 31, 20x2, the ratio of total contributed capital to committed capital was 90%.

*See standard disclosures in the Operating model illustrative financial statements.
Disclosures unique to the Non-Operating model are provided below.*

14. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

***Basis of Presentation** — See operating model illustrative financial statements.*

***Use of Estimates** — See operating model illustrative financial statements.*

Real Estate Equity Investments — Investments in real estate are carried at fair value. Cost to acquire real estate investments are capitalized as a component of investment cost. In certain investment arrangements, the Fund’s equity percentage interest in the investment may be reduced by third party residual interests for returns realized in excess of specific hurdle rates of return. Such residual interests have been considered in the related investment valuation.

***Investments in Mortgage Loans and Notes Receivables** — See operating model illustrative financial statements.*

Investment Valuation — The fair values of real estate investments are estimated based on the price that would be received to sell an asset in an orderly transaction between marketplace participants at the measurement date. Investments without a public market are valued based on assumptions made and valuation techniques used by the Advisor. Such valuation techniques include discounted cash flow analysis, prevailing market capitalization rates or earnings multiples applied to earnings from the investment, analysis of recent comparable sales transactions, actual sale negotiations and bona fide purchase offers received from third parties, consideration of the amount that currently would be required to replace the asset, as adjusted for obsolescence, as well as independent external appraisals. In general, the

Advisor considers multiple valuation techniques when measuring the fair value of an investment. However, in certain circumstances, a single valuation technique may be appropriate. The Fund's policy is to obtain independent external appraisals for investments every 12 months. Investments in publicly traded equity securities are valued based on their quoted market prices.

The fair value of real estate investments does not reflect the Fund's transaction sale costs, which may be incurred upon disposition of the real estate investments. Such costs are estimated to approximate 2% - 3% of gross property fair value. The Fund also reflects its real estate equity investments net of investment level financing. Valuation adjustments attributable to underlying financing arrangements are considered in the real estate equity valuation.

The Fund may invest in real estate and real estate related investments for which no liquid market exists. The market prices for such investments may be volatile and may not be readily ascertainable. In addition, there continues to be significant disruptions in the global capital, credit and real estate markets. These disruptions have led to, among other things, a significant decline in the volume of transaction activity, in the fair value of many real estate and real estate related investments, and a significant contraction in short-term and long-term debt and equity funding sources. This contraction in capital includes sources that the Fund may depend on to finance certain of its investments. These market developments have had a significant adverse impact on the Fund's liquidity position, results of operations and financial condition and may continue to adversely impact the Fund if market conditions continue to deteriorate. The decline in liquidity and prices of real estate and real estate related investments, as well as the availability of observable transaction data and inputs, may have made it more difficult to determine the fair value of such investments. As a result, amounts ultimately realized by the Fund from investments sold may differ from the fair values presented, and the differences could be material.

Concentrations of Credit Risk — See operating model illustrative financial statements.

Cash and Cash Equivalents — See operating model illustrative financial statements.

Mortgage Loans Payable — See operating model illustrative financial statements.

Interest Rate Swaps and Caps — See operating model illustrative financial statements.

Income and Expense Recognition — Distributions from real estate equity investments are recognized as income when received to the extent such amounts are paid from earnings and profits of the underlying investee. Interest income on real estate debt investments is generally accrued as earned in accordance with the effective interest method. For loans in default, interest income is not accrued but is recognized when received. Expenses are recognized as incurred.

The Fund generally records realized gains and losses on sales of real estate investments pursuant to the provisions of Statement of Financial Accounting Standards No. 66, Accounting for Sales of Real Estate (“SFAS No. 66”). The specific timing of a sale is measured against various criteria in SFAS No. 66 related to the terms of the transaction and any continuing involvement in the form of management or financial assistance associated with the property.

Investment Advisory Fees — *See operating model illustrative financial statements.*

Income Taxes — As a partnership, the Fund itself is not subject to U.S. Federal income taxes. Accordingly, income taxes are not considered in the accompanying financial statements since such taxes, if any, are the responsibility of the individual partners. Income from non-U.S. sources may be subject to withholding and other taxes levied by the jurisdiction in which the income is sourced.

Guarantees — *See operating model illustrative financial statements.*

Foreign Currency — *See operating model illustrative financial statements.*

Risk Management — *See operating model illustrative financial statements.*

Change in Accounting Principle — *See operating model illustrative financial statements.*

15. FAIR VALUE MEASUREMENTS

Effective January 1, 2008, the Fund adopted FASB Statement No. 157, *Fair Value Measurements* (“FAS 157”) and FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (“FAS 159”). FAS 157 provides a definition of fair value which focuses on an exit price rather than an entry price, establishes a framework for measuring fair value which emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and requires expanded disclosures about fair value measurements. FAS 159 provides companies with the option to report eligible financial assets and financial liabilities at fair value on an instrument-by-instrument basis. This option is available when an entity first recognizes a financial asset or financial liability or upon signing a firm commitment. In addition, FAS 159 allows a one-time election for existing qualifying financial assets and liabilities. Upon adoption of FAS 159, the Fund elected to account for its debt liabilities at fair value in part to comply with industry reporting standards that require all debt liabilities to be reported at fair value. The adoption of FAS 157 and 159 did not have a material impact on the Fund’s financial position or results of operations on the effective date.

In December 2007, the FASB issued Statement No. 141R, *Business Combinations* (Statement 141R), and Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment to ARB No. 51 (Statement 160)*. Statements 141R and 160 require most identifiable assets, liabilities, noncontrolling interests, and goodwill acquired in

a business combination to be recorded at “full fair value” and require noncontrolling interests (previously referred to as minority interests) to be reported as a component of equity, which changes the accounting for transactions with noncontrolling interest holders. (For purposes of this illustration, assume both Statements were effective as of January 1, 20x8). Statement 141R is applied to business combinations occurring after the effective date. Statement 160 is applied prospectively to all noncontrolling interests, except the presentation and disclosure requirements. The presentation and disclosure requirements were applied retrospectively for all periods presented, as follows: (i) the noncontrolling interest was reclassified to equity, and (ii) consolidated net income was adjusted to include the net income attributed to the noncontrolling interest.

To increase consistency and comparability in fair value measurements and related disclosures, the Fund utilizes the fair value hierarchy required by FAS 157 which prioritizes the inputs to valuation techniques used to measure fair value into three broad levels:

Level 1 — Quoted prices in active markets for identical securities.

Level 2 — Prices determined using other significant observable inputs. Observable inputs that other market participants would use in pricing a security, including quoted prices for similar securities.

Level 3 — Prices determined using significant unobservable inputs. Unobservable inputs reflect the Fund’s own assumptions about the factors market participants would use in pricing an investment, and would be based on the best information available in the circumstances.

A summary of the inputs used, as of December 31, 20x2, involving the Fund’s assets and liabilities carried at fair value, is as follows (dollars in thousands):

Description	Total	Level 1	Level 2	Level 3
Real estate equity investments	\$ -	\$ -	\$ -	\$ -
Real estate debt investments				
Mortgage loans payable				

The following is a reconciliation of assets and liabilities for which significant unobservable inputs (level 3) were used in determining fair value (dollars in thousands):

Real Estate Equity Investments	Real Estate Debt Investments	Mortgage Loans Payable
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Beginning balance
 Realized and unrealized gains
 Cost of purchases
 Proceeds of sales
 Principal repayments
 Ending balance

Amount of unrealized gain/loss reported in the
 statement of operations attributable to
 investments held at year end

- 16. **MORTGAGE LOANS PAYABLE** — *See operating model illustrative financial statements*
- 17. **INTEREST RATE SWAPS AND CAPS** — *See operating model illustrative financial statements*
- 18. **PORTFOLIO DIVERSIFICATION** — *See operating model illustrative financial statements*
- 19. **INVESTMENT ADVISOR FEES** — *See operating model illustrative financial statements*

Investment advisory fees for investments under management by ABC are billed at a rate of 15.0 basis points per quarter for the first \$200 million of gross asset value, 13.5 basis points per quarter for the next \$300 million of gross asset value, and 12.0 basis points per quarter thereafter, in arrears. ABC also earns acquisition fees equal to 75 basis points on acquisition costs.

For the years ended December 31, 20x8 and 20x7, total management fees earned by ABC totaled \$1,250,000. Management fees of \$350,000 were unpaid as of December 31, 20x8 and 20x7.

Partners' capital contributions and distributions are made in proportion to respective committed capital amounts until cumulative distributions have provided limited partners with a realized internal rate of return of 8%. Thereafter, incentive distributions will be made to the general partner equal to 20% of subsequent distributions. Income and loss is allocated among the partners so as to conform to expected distributions. At December 31, 20x8 and 20x7, aggregate unrealized incentive allocations made to the general partner were \$800,000 and \$700,000, respectively.

20. FINANCIAL HIGHLIGHTS

The following summarizes the Fund's financial highlights, consisting of total return and expense and net investment income ratios, for the years ended December 31, 20x8 and 20x7:

	20X8 Limited Partners	20X7 Limited Partners
Total return ¹		
End of period since-inception internal rate of return	%	%
Beginning of period since-inception internal rate of return	%	%
Expense ratios ²		
Operating expense	%	%
Incentive allocation	%	%
Total expenses and incentive allocation	%	%
Net investment income ratio ³	%	%

¹ Total return is calculated based on a dollar-weighted internal rate of return methodology net of fees and incentive allocations. The internal rate of return is computed on a since-inception basis using annual compounding and the actual dates of cash inflows received by and outflows paid to investors and including ending net asset value as of each measurement date. Because total return is calculated for the limited partners taken as a whole, an individual limited partner's return may vary from these returns based on different management fee and incentive arrangements (as applicable) and the timing of capital transactions.

² The expense ratios are calculated for the Limited Partners taken as a whole using weighted average net assets for the period. The computation of such ratios based on the amount of expenses and incentive allocations assessed to an individual Limited Partner's capital may vary from these ratios based on different management fee and incentive arrangements (as applicable) and the timing of capital transactions.

³ The net investment income ratios are calculated for the Limited Partners taken as a whole using weighted average net assets for the period. The computation of the net investment income ratio based on the amount of net investment income assessed to an individual Limited Partner's capital may vary from these ratios based on different management fee arrangements (as applicable). The net investment income ratio does not reflect the effects of any incentive allocation.

21. COMMITMENTS AND CONTINGENCIES

22. SUBSEQUENT EVENTS

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