

REIS ADOPTING RELEASE

Summary of Notes Payable Accounting Standards and Related REIS Modifications

Issued by the Real Estate Information Standards Council in conjunction with the
National Council of Real Estate Investment Fiduciaries

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Executive Summary:

Accounting and valuation for notes payable in a fair value environment continues to be an area where mixed practices exist in the institutional real estate investment industry. Real estate fund managers, investors and related participants in the industry continue to have differing opinions in regard to the basis for liability valuation, and the accounting and valuation principles that apply. In addition, concerns continue to exist with regard to the comparability of investment performance returns between managers as a result of differing views and policies on notes payable. In this regard, significant efforts have been undertaken by NCREIF participants, including the Debt Task Force assembled to gather data, research and opinions on this important matter. Such efforts included a public comment process on the proposed amendment, which commenced on July 1, 2005 and ended on August 31, 2005. Efforts were also undertaken in order to understand views expressed by, and research conducted by, the Financial Accounting Standards Board and related US accounting standards bodies. While recognizing that liability accounting and valuation is more complex than one might expect, we believe the overriding objective of fair value accounting and valuation for real estate investment vehicles is arguably simple. The objective is to account for and to value assets and liabilities at the amount at which such assets and liabilities could be sold, settled or exchanged in a current transaction.

With this overriding principle in mind, REIS has been modified in order to narrow accounting and valuation practices such that they meet the fundamental objective described above.

Modifications to REIS Standards:

* Deleted paragraph 1.11 of the Market Value Accounting Policy Manual as follows:

~~Investment Vehicles—Special Considerations~~

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

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

* Amended Section 3 of the Market Value Accounting Policy Manual as follows:

3. Notes Payable

~~For additional guidance on this topic, please see the Debt Accounting Workbook, which is available at www.ncreif.org~~

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

3.02 [Reserved for future use.] ~~A primary condition of market value accounting is that asset and liability carrying amounts, including unrealized gains and losses, would be realized by investors in an assumed transaction at the balance sheet date (i.e. transferability). Investors in real estate investment vehicles may realize their investments through sales of entity level interests or through selling underlying assets and settling underlying liabilities of the investment vehicle. In determining the approach used to estimate the market value of notes payable, industry participants should consider whether it is more likely than not that the liability carrying amounts would be realized by investors through entity level transactions or through transactions involving the underlying debt instruments. NCREIF believes that for investment vehicles where trading of entity level interests is likely, the approach used to estimate the market value of notes payable should generally be based upon the present value of expected future debt service payments. Conversely, for investment vehicles where trading of entity level interests is not likely, the approach used to estimate the market value of notes payable should generally be based upon the amount at which the liability could be settled in a current transaction. However, industry participants should consider all relevant facts and circumstances of an investment vehicle when adopting the preferable notes payable valuation approach for that vehicle.~~

3.03 Unless prohibited by accounting principles generally accepted in the United States of America, notes payable are required to be carried at market value as described in paragraph 3.05. The market value of notes payable should be reported separately from that of the related encumbered assets. Changes in market financing terms should not

affect the valuation of collateral. Adjustments to the estimated market value of notes payable should be reported as unrealized gain (loss) in the statement of operations. Gains and losses realized upon settlement of notes payable, net of transaction and prepayment costs, if any, should be reported as realized gain (loss) in the statement of operations. ~~The approach used for estimating the market value of notes payable is as follows:~~

~~For investment vehicles where trading of entity level interests is likely:~~

~~3.04 For notes payable that are prohibited by US GAAP to be carried at market value, disclosures are required to be provided with quarterly and annual client financial reporting which disclose the market value of notes payable in accordance with paragraph 3.05. Such disclosures should include a description of the supplemental accounting policy for notes payable. The preferable approach to estimate the market value of notes payable is based on the present value of the future debt service payments that the vehicle expects to pay through the eventual settlement of the liability, discounted at currently prevailing interest rates for comparable debt. The applicable interest rate should consider changes in real estate and capital markets conditions, business and collateral risks, and other applicable factors. Future debt service payments should include all amounts for which the borrower has the ability and intent to pay including expected prepayment costs, if applicable. If the obligation is expected to be satisfied via the transfer of collateral, the market value of such collateral expected to be transferred should be included as a component of future debt service.~~

~~For investment vehicles where trading of entity level interests is not likely:~~

~~3.05 The market value of notes payable is based on the amount at which the liability could be settled or exchanged in a current transaction between knowledgeable, unrelated willing parties, exclusive of direct transaction costs. Direct transaction costs include only those costs, or that portion of such costs, that are unrelated to changes in effective interest rates since the date of origination of a loan. The preferable approach to estimate the market value of notes payable is based on the amount at which the liability could be settled in a current transaction, exclusive of direct transaction costs. Direct transaction costs should be included in the estimate of market value at the time it becomes probable they will be incurred. Prepayment fees based on a predetermined amount or ratio unrelated to changes in interest rates are considered to be direct transaction costs which are probable they will be incurred at the time management with the appropriate authority has made a decision to prepay the notes. Prepayment penalties based on yield maintenance provisions are not considered to be direct transaction costs to the extent such penalties result from changes in interest rates. Generally, unrealized gains on notes payable should only be recognized if the related note is transferable to third parties, or if the transfer of collateral with a market value lower than the outstanding principal balance could be used to settle the liability.~~

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

~~short term obligations may approximate the contractual amount because the relatively short period of time may not materially affect the time valued, risk adjusted amount.~~

3.07 When management makes a decision to prepay or to exchange a loan associated with a specific investment, net asset value should be adjusted to reflect transaction costs, including the full cost of prepayment and yield maintenance costs. ~~The costs of obtaining a mortgage loan, as well as points and interest rate buy downs, are discussed in the section on deferred costs~~

Recommended Financial Statement Disclosure

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

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

Appendix A - Basis for Conclusions Reached

A1. Among other work conducted by the debt task force, US GAAP accounting standards and related guidance were researched in order to evaluate the question of whether net asset value in a real estate fair value environment is intended to represent investor equity in a real estate investment vehicle assuming all assets and liabilities were sold, settled or exchanged at their respective fair values at the balance sheet date. Our research indicated this may not necessarily be consistent with the principles currently established within US GAAP for investment companies, which states that “investments” should be carried at fair value but those assets and liabilities which are not investments should not be carried at fair value. However, in light of the fact that US GAAP requires institutional investors to carry their investments in real estate funds at fair value, and considering the highest and best use principles described within FASB’s fair value measurements project, it is unclear to us as to why certain assets or liabilities within a real estate fund would be exempt from the requirement to be presented at fair value. Further, upon considering the substance of activities that occur within real estate funds, and in particular the interchangeable use of fund level financing with property financing, it becomes apparent that investment results should reflect changes in the fair value of assets and liabilities in order to report meaningful economic performance. Accordingly, we believe such fair value measurement principles should be applied to all assets and liabilities in a real estate fund. This accounting and valuation principle for assets and liabilities is further clarified by an overriding recognition that fair value is not liquidation value, net realizable value or investment value, but is equivalent to market value as commonly defined in the industry. In addition, our research indicated that the accounting and valuation objective for assets and liabilities is exclusive of direct costs to sell (or direct costs to settle or exchange). Such amounts are only considered in net asset value at the time a decision has been made to sell, settle or exchange the investment.

A2. Task Force deliberations noted that the principles to be applied in the measurement of notes payable liabilities are consistent with the market value principles that apply to asset valuation which emphasize market inputs. Such principles include an overriding objective to value assets and liabilities at amounts at which such assets and liabilities could be sold, settled, exchanged in a current transaction at the date of the balance sheet. The absence of duress such as that found in a forced transaction, and the absence of an entity’s intent to enter into a current transaction are important considerations to remember when measuring the market value of notes payable.

A3. Perhaps more important was the recognition that all fair value measurements are fundamentally market-derived; i.e. the methodology, assumptions, and rationale used should mimic observed market behaviour in current transactions. In this regard, absent highly liquid market circumstances, it is critical to recognize that valuation methods can never be formulaic, as market behaviour at times considers such a wide range of variables that considerable judgement would always be required as part of any value conclusion. Additionally, our efforts concluded that where financing is utilized for investments, it is critical to recognize that the concept of an investment pertains to the net equity position

held by the investor. Accordingly, in regard to accounting and valuation for investment level notes payable, considerable attention should be focused not necessarily on the debt itself, but on the overall conclusion surrounding the valuation of the net equity investment. Said differently, the Task Force believes the key focus should be directed toward the measurement of the impact on the value of an investment that liabilities have that reside within an investment.

A4. Other considerations include a general acknowledgement that real estate funds cannot ignore the economic impact of unfavourable or favourable debt when such amounts are obtained as financing in connection with a specific real estate investment and a general recognition that liability value conclusions should be based on a prudent borrower principle. Said differently, when alternatives exist, borrowers will generally execute the most economically beneficial transaction to settle its obligations. (Similar to the highest and best use principle used for asset valuation.)

A5. In regard to the principle of direct transaction costs, as is consistent with asset valuation, liability valuation should also be exclusive of direct transaction costs in the absence of a decision to prepay or to settle debts. While liability transaction costs are generally considered to include prepayment fees, prepayment penalties, defeasance costs and/or other costs that may be incurred in connection with settling the debt with the lender or transferring the debt to a buyer, *direct* transaction costs include only those costs, or that portion of such costs, that are unrelated to changes in effective interest rates since the date of origination of a loan. Accordingly, indirect transaction costs, which must be considered in the valuation of such liabilities, consist of costs that would be incurred in a current transaction as a result of changes in effective interest rates since loan origination. An example of a direct transaction cost would be a prepayment fee based on 1 % of the outstanding principal balance. Such payments are direct transaction costs as changes in effective interest rates since the date of loan origination have no impact on such costs. An example of an indirect transaction cost can be illustrated by examining a yield maintenance penalty provision. Certain loans contain early repayment penalties that are based on the yield provided by a benchmark rate, such as an adjusted U.S. treasury security rate. If such a loan is repaid on the date of loan origination, a penalty is incurred by the borrower even though effective rates had not changed. In such circumstances, the penalty is a direct transaction cost as changes in effective interest rates since the date of loan origination have no impact on such costs. Alternatively, in the event effective interest rates had declined since loan origination and a borrower were to incur a yield maintenance penalty upon subsequent early repayment, then, in those circumstances, the portion of the yield maintenance penalty arising from a decline in interest rates is an indirect transaction cost. When a decision has been made by management to prepay or to settle a loan associated with a specific investment, net asset value should include the cost of all transaction costs (direct and indirect, which therefore includes the full cost of prepayment costs/yield maintenance costs). The criteria used for management's decision should be consistent with the "Held for Sale" criteria described in FAS 144 paragraph 30.

A6. In terms of principles to be applied in the valuation process, valuation for liabilities should fundamentally mirror the valuation framework used for asset valuation. In other

words, various approaches for value should be considered with an overall reconciliation process applied as part of the value conclusion. The final value conclusion will require significant judgment and will need to carefully consider all facts, circumstances, rights and obligations that exist for the borrower. Importantly, the final value conclusion will need to meet the current transaction principle described above.

A7. In this regard, the general framework for debt valuation should consider the following approaches:

- A settlement analysis: Most loan documents permit the prepayment of the liability based on specific terms and conditions. In addition, many loans provide the borrower with rights to allow third parties to assume the loan. The settlement analysis should reflect contractual costs and penalties required and should be completed as a basis for comparison to the other approaches. If the loan cannot be assumed, this may be the primary valuation approach used in the overall value conclusion.
- A present value analysis: The present value of the spread between the market interest rate and the contract interest rate should be estimated over the remaining term of the mortgage.
 - a. The market interest rate selection can be from a combination of sources. However, it should be noted that consistent selection mechanism will best support the differences among investments valued within the same time period and the variances noted of the same investment period over period. Judgment needs to be exercised in order to arrive at a credible conclusion.
 - b. The term selected for the market interest rate should generally be consistent with rates that consider the term remaining on the existing note being valued. However, market-derived inputs would need to be considered and it is possible that remaining, existing or most probable terms could be applicable based on the facts and circumstances being valued. In either case, the rationale used should be consistent with actual sales, settlements or exchanges occurring in the marketplace on the balance sheet date.
 - c. The market interest rate should consider the effect of an entity's credit standing or the credit standing of the related collateral in circumstances involving collateral-dependent borrowing arrangements.
- Market Testing, including Comparable Transactions - Actual transactions should be investigated to extract the adjustments as indicated by the actions of active participants, i.e. market approach to the adjustment. Any adjustment that is indicated via any methodology should reflect market perceptions of the adjustment. Interviews of buyers and sellers to determine if the financing terms would affect value, and by how much, is the best way to verify a market adjustment, if market-derived evidence is not readily obtainable.
- Leveraged Equity Analysis - A leveraged equity analysis indicating the implied equity yield rate should be performed as a reasonableness test. This implied

equity yield rate should reflect a market-oriented rate, not investor specific. Considerations of applicable equity rates should include risk associated with specifics of the collateral property, as well as loan-to-value, debt service coverage throughout the projected term of the mortgage and at the end of the existing loan. If a refinancing scenario is the most market-oriented, interest rate risk should be included in the selection of the market interest rate at the refinance period.

- Reconciliation: The value conclusion will be based on the facts and circumstances including the relative weight of the most applicable analyses. Sensitivity analyses and tests of reasonableness should be analyzed and considered.

Appendix B – Alternatives Considered

Certain feedback received during the exposure draft process inquired of the perceived negative consequences of a REIS departure from its dependency on US GAAP and the alternatives considered. In this regard, perceived benefits and risks of certain alternatives indicated below were outlined in order to provide additional information to parties commenting on the exposure draft.

Three alternatives are outlined below, which are referred to as:

Alternative A – the “US GAAP Compliance” alternative;

Alternative B – the “Economic Authenticity” alternative; and

Alternative C – the “Supplemental Reporting” alternative.

Alternative A – the “US GAAP Compliance” alternative requires consistent use of the market value basis of accounting under US GAAP for reporting of accounting information and for reporting of performance returns. As a result, fund level debt would be required to be reflected at amounts outstanding rather than at market value. Supplemental reporting of market value information for fund level debt could be provided through supplemental information, but would not be reflected in performance returns.

Perceived benefits:

- Maintains fundamental reliance on dependent standards such as US GAAP.
- Provides investors with required GAAP information under laws, regulations, contracts
- Allows for unqualified GAAP opinions
- Avoids the confusion of different books in alternative C

Perceived risks:

- Diverts from perceived actual economic results
- Results in performance reporting and reporting of index information that is perceived to be misleading due to perceived shortcomings of US GAAP, including the prohibition for carrying fund level debt at fair value.
- Perceived risk that adherence to US GAAP will result in additional inappropriate changes in the near term as a result of expected US GAAP changes for real estate funds, which could include changes in income reporting and changes prohibiting other fund level assets and liabilities from being carried at fair value.

Alternative B – the “Economic Authenticity” alternative requires use of the market value basis of accounting under US GAAP, adjusted for selected items such as fund level debt, for reporting of accounting information and for reporting of performance returns. As a result, fund level debt would be required to be reflected at market value for accounting and performance purposes rather than amounts outstanding as required by GAAP. Supplemental reporting of amounts outstanding or other differences to US GAAP could be provided through supplemental information, but would not be reflected in performance returns.

Perceived benefits:

- Reporting is based on the perceived best measure of economic results and return performance
- Avoids perceived shortcomings of US GAAP reporting which would taint performance reporting
- Avoids the added confusion of two sets of books and records
- Potential to mitigate perceived US GAAP risks if REIS maintains only selected understandable differences to US GAAP vs. wholesale differences
- Potential to allow for auditable standard in accordance with REIS standards but not US GAAP standards.
- Information to allow investor compliance with US GAAP is provided

Perceived risks:

- Risk that lack of compliance and wholesale divergence from US GAAP renders REIS irrelevant
- May violate fund managers' requirements for compliance with GAAP
- Could impact managers' compliance with GIPS

Alternative C – the “Supplemental Reporting” alternative requires consistent use of the market value accounting under US GAAP with supplemental reporting of identified non-GAAP differences. Such non-GAAP differences would include for example, the mark to market impact of fund level debt. For reporting of REIS compliant performance returns and for reporting of index information, non-GAAP reporting measures would be utilized.

Perceived benefits:

- Allows for accounting compliance with US GAAP
- Meaningful non-GAAP information is provided on a supplemental basis
- REIS compliant performance reporting and index reporting is meaningful

Perceived risks:

- Requires difficult and potentially awkward explanations to investors
- Introduces significant investor confusion resulting from two sets of numbers for NAV, for income, appreciation and net income amounts, not to mention different books for client financial statement reporting and client performance reporting.
- Results in risk of investor perception of tampering
- Increases uncertainty over which numbers are correct
- Increases administrative burden of managers in terms of IT systems, processes and controls, and additional recordkeeping
- Introduces performance return and index complexities from two sets of numbers
- Could require primary and supplemental performance return information

During the REIS Council meeting on Wednesday, October 19, 2005, certain REIS Council members, primarily representing the Performance Measurement and Accounting

committees, provided feedback from their respective standing committees which noted a strong preference, if not mandate, voiced in the public comment process for GAAP-based standards. In response to the feedback received, the REIS Council voted in favour of Alternative A – The “US GAAP Compliance” alternative.

Appendix C - Public Comment Process

The key issues and questions considered by industry participants as part of the public comment process for the debt exposure draft are as follows:

1. The Financial Accounting Standards Board and the Accounting Standards Executive Committee of the AICPA have projects currently underway that are expected to provide guidance for the measurement and accounting for notes payable liabilities. Because it appears such projects need additional work at the present time and may not be completed until sometime in 2006, we have proposed current amendments to REIS in an attempt to narrow existing practices in the immediate future. Some believe this course of action is preferential to waiting for the FASB and/or AICPA to make an authoritative decision on this critical matter. At present, the Task Force believes the approach that is proposed for the measurement of liabilities within REIS appears to be consistent with the conceptual framework put forth by FASB in its *Fair Value Measurements* project. For example, FASB clarified in the project that the fair value of a liability should be determined using a settlement or “layoff” notion. However, FASB has not completed its project and different interpretations and principles could arise which are not contemplated as of this time. Do you agree that current changes to REIS are warranted in light of the risk that the FASB or AICPA may ultimately take a differing authoritative view with regard to fair value accounting and valuation principles for notes payable?

Many respondents indicated that changes to REIS were warranted at this time and that improving reporting now was preferable to inaction. Other respondents indicated a preference to allow FASB or AICPA to address such issues and for REIS to follow the actions of those standard-setters. The REIS Council considered that changes were warranted at this time based on the risk of an extended period of time before US standard-setters adequately addressed the issues discussed herein as well as the current benefits of improved reporting.

2. Existing industry standards allow for investment vehicles to use one of two approaches for debt accounting and valuation; either a fair value approach in paragraph 3.05 of the NCREIF Market Value Accounting Policy Manual, or an investment value approach in paragraph 3.04. This exposure draft proposes a single approach for all investment vehicles as currently described in paragraph 3.05. Do you agree that a single approach is prudent?

A significant number of respondents indicated a strong desire for a single approach. The REIS Council considered a single approach to be prudent at this time.

3. Some preparers of financial statements and accounting firms believe that generally accepted accounting principles in the US currently require investment level debt to be carried at fair value but prohibit fund level debt to be carried at fair value within an investment fund’s fair value financial statements. Others

believe that GAAP requires notes payable in an investment company (investment level or fund level) to be carried at the amount payable, less unamortized premium or discount. In addition, while the AICPA project referred to above is expected to consider fund level debt accounting and valuation principles, it currently appears that it is highly unlikely that any changes to the prohibition for valuation of fund level debt will occur for many years to come. It is also possible that there are circumstances where US GAAP will prohibit other fund level assets and liabilities from being carried at fair value and that other changes may occur which result in a perception of misleading US GAAP reporting for private real estate equity investors. For example, the use of tax law as a basis for income reporting to tax exempt investors is perceived by some to render income returns as misleading. Many believe that real estate accounting in a fair value environment should require all assets and liabilities to be stated at fair value and that the exclusion of certain assets and liabilities, fund level debt in this case, not only increases the risk of unintended consequences of reporting but also misrepresents the economic authenticity of investment results and increases the risk of inconsistent reporting of investment results among investment managers. Others point out that compliance with US GAAP is a fundamental belief inherent in Real Estate Information Standards. They note that real estate fund investors, lenders, and other stakeholders often rely on GAAP reporting and often require that reporting comply with GAAP under related contractual arrangements. Further, parent companies and equity method investors in real estate funds may be required under federal securities laws or by regulatory agencies to report investment results in accordance with US GAAP. Accordingly, they believe that REIS should maintain strict compliance with GAAP in order to eliminate the added confusion of non-GAAP reporting and to mitigate the risk of irrelevance. Upon considering the available alternatives (see Appendix B – Alternatives Considered), the REIS Council has recommended that there be no accounting distinction for fund level debt and that such accounting and valuation standards be consistent with investment level debt in part because of the perceived risks of misleading reporting together with a lack of clear guidance involving a fund vs. investment level distinction. Please provide us with your comments on the following:

- whether you believe REIS should be established based on a principle of economic authenticity or whether you believe that REIS should maintain its dependency on US GAAP now and in the future?
- whether additional changes to US GAAP that result in perceived misleading reporting would change your view on REIS dependency with US GAAP?
- whether industry acceptance of an auditable accounting standard in compliance with REIS (rather than compliance with GAAP) would be acceptable for your organization and your investors?

Many respondents indicated a very strong preference, if not mandate, to continue to provide investors with US GAAP compliant financial reporting. Many also indicated that this preference is unlikely to change in spite of additional changes to US GAAP.

Others indicated a strong belief in the principle of economic authenticity for purposes of industry reporting. The REIS Council considered the US GAAP mandate to be critical for purposes of primary reporting and noted that reporting of supplemental information is often an effective mechanism for reporting of meaningful information to investors.

- 4.** Paragraphs 3.05 and 3.06 explain the distinction of direct vs. indirect transaction costs and clarifies that REIS generally requires unrealized losses on notes payable to be recognized when prevailing interest rates decline below those fixed rates obtained at loan origination. Is this clarification sufficient or is additional application guidance or explanation required?

While a majority of respondents indicated that sufficient information was available in the modified standards in regard to the distinction of direct and indirect transaction costs, others indicated that additional examples would be helpful. The REIS Council considered that it would be appropriate to provide for additional illustrations of direct vs. indirect transaction costs, which have been incorporated in paragraph A5.