1993

Real estate industry developments - 1993; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

Real Estate Industry Developments—1993

AICPA

American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of the financial statements of real estate enterprises with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Gerard L. Yarnall
Director, Audit and Accounting Guides

The staff of the AICPA is grateful to the members of the AICPA Real Estate Committee for their contribution to this document.

1 2 3 4 5 6 7 8 9 0 AAG 9 9 8 7 6 5 4 3

Table of Contents

Page

Real Estate Industry Developments—1993 5

Industry and Economic Developments 5

Regulatory Developments 6

Audit Issues 9

Accounting Developments 14

Real Estate Industry Developments—1993

Industry and Economic Developments

Virtually all sectors of the U.S. real estate industry have experienced rather drastic and fundamental shifts over the past several years and signs of stabilization are just beginning to emerge. As the economy in general slowed down, activity in the real estate industry took a significant downturn and asset values plunged in many areas of the country after years of record surges. Actual market conditions vary by geographic region and by asset type, but some general trends are clearly discernible.

Commercial properties were particularly hard hit, with an oversupply of most kinds of space in almost every major market. Economic recession, changing demographics, and the trend toward corporate downsizing were primary contributors to the problems in this sector. As many businesses pursued cost reductions and reduced the numbers of employees on their payrolls, the need for office space was reduced. Many also delayed planned expansions.

Decreases in equity resulting from overall declines in real estate values have led to the abandonment of properties by some owners and to an increasing number of foreclosures by financial institutions. The increased ownership by financial institutions and other lenders tends to exacerbate the downward pressure on values as the unwilling owners try to dispose of the properties at fire-sale prices.

As a result, capital is virtually unavailable to the industry except for projects with proven economic viability. Banks and savings institutions have become reluctant to lend as a result of both past experience and the current regulatory environment, which subjects real estate loans to a high degree of scrutiny.

The markets for apartments and for single-family homes, on the other hand, seem to be faring better. Spurred by the lowest mortgage interest rates in several decades, buyers are coming back into the market and finding properties more affordable. As a result, recovery in that sector seems to be taking hold.

As a result of the overbuilding in both the commercial and residential sectors, vacancy rates are high and selling prices of many properties held for sale are depressed. In such circumstances, conditions such as the following may indicate a need to question the values at which certain real estate investments are carried:

- Cash flows from operating activities are insufficient to cover debt service.
- Current occupancy rates indicate that future cash flows to be received from the investment are lower than the amounts needed to fully recover the investment's carrying amount.
- Major tenants are experiencing financial difficulties.
- A large number of leases will expire in the near term.
- Lessors are having to make significant concessions in order to rent property.
- Properties held for sale remain unsold at subsequent balance-sheet dates.
- Other investors have decided to cease providing support or to reduce their financial commitment to a project or venture.
- Auditors' reports on financial statements of investee properties or significant debtors are modified for reasons that relate to real estate investments or mortgage loans.

As in prior down cycles in the real estate industry, there is renewed interest in the formation of real estate investment trusts (REITs). For owners and developers, REITs provide an alternative method of raising capital in a tight credit market. For investors, REITs offer a securitized investment that is an attractive alternative during a period of low interest rates. Currently, cash dividend yields of REITs are averaging about 6.5 percent compared with money market interest rates of 3 percent or less. During 1993, over $5 billion in REIT offerings were sold, triple the 1992 pace. The market value of REITs is currently about $25 billion, compared with $6 billion three years ago.

Regulatory Developments

AICPA Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards,* vol. 1, AU sec. 311), requires that in planning their audits, auditors consider matters affecting the industry in which the entity operates including, among other things, government regulations. Auditors consider such regulations in light of their potential impact on the financial statements being audited. SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards,* vol. 1, AU sec. 317), distinguishes between the following two types of laws and regulations:

1. Those that have a direct and material effect on the determination of financial statement amounts
2. Those that relate more to an entity's operating aspects than to its financial and accounting aspects and, therefore, have only an indirect effect on the financial statements

While auditors should design their audits to provide reasonable assurance of detecting material misstatements of the financial statements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts, an audit performed in accordance with generally accepted auditing standards (GAAS) does not include procedures specifically designed to detect illegal acts that would have only an indirect effect on the financial statements. Nonetheless, auditors should be aware of the possibility that such illegal acts may have occurred.

Real estate entities and the transactions in which they engage have become the focus of an increasing level of government regulation. Laws and regulations that affect the real estate industry are discussed in the paragraphs below.

Securities and Exchange Commission Regulations

Sellers of investments in real estate, such as interests in limited partnerships, may become subject to the same Securities and Exchange Commission (SEC) registration and reporting requirements that affect other issuers of securities. Sellers of both public and private investments in real estate should prepare and file all required disclosure documents (prospectuses or offering documents) to prevent future claims by buyers that disclosures were inadequate or misleading. If the required disclosures have not been made, auditors should be alert to the existence of possible claims by buyers that may lead to the recision of sales transactions and refunds of purchase prices.

U.S. Department of Housing and Urban Development Regulations

Through the Federal Housing Administration, the U.S. Department of Housing and Urban Development (HUD) regulates the development and operation of all projects for which it insures mortgages or provides rent subsidies. Entities that receive financial assistance from HUD are required to submit audited financial statements to HUD annually. The audits of those financial statements are required to be performed in accordance with GAAS, *Government Auditing Standards,* issued by the Comptroller General of the United States and commonly referred to as the Yellow Book, and the *Consolidated Audit Guide for HUD Programs,* issued by the HUD Office of the Inspector General (OIG).

In July 1993, the HUD OIG issued a revised *Consolidated Audit Guide for Audits of HUD Programs,* which is effective for audits of financial statements for fiscal years ending September 30, 1993, and thereafter. The revised Guide provides program-specific audit requirements for entities that—

- Participate in HUD Section 8 programs.
- Participate in insured and coinsured multifamily projects.
- Receive HUD-held mortgages, direct loans, capital advances, and other subsidies.
- Have insured development certifications.
- Issue Government National Mortgage Association mortgage-backed securities.
- Are HUD-approved Title II nonsupervised mortgagees and loan correspondents.
- Are HUD-approved Title I nonsupervised lenders and loan correspondents.

Significant changes in the revised Guide include the incorporation of final rules (dated December 9, 1992) for mortgage approval reform and direct-endorsement expansion and for implementing Office of Management and Budget Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.* The revised Guide also deletes the "common" compliance requirements contained in the prior Guide and provides revised suggested audit procedures for testing compliance with laws and regulations. Copies of the revised Guide (stock number 023-000-00805-0) can be obtained by writing to the Government Printing Office, Superintendent of Documents, Mail Stop SSOP, Washington, D.C. 20402-9328. The document can be ordered by phone—(202) 783-3238—or fax—(202) 512-2250—and charged on Visa or MasterCard.

Interstate Land Sales Full Disclosure Act

Developers are required to make full disclosure in connection with the sale or lease of certain undeveloped subdivided land. The Interstate Land Sales Full Disclosure Act makes it unlawful for a developer to sell or lease, by use of the mail or any other means of interstate commerce, any land offered as part of a common promotional plan unless the land is registered with the Office of Interstate Land Sales Registration. The Act requires that a printed property report be furnished to all prospective purchasers or lessees. Similarly, the Federal Trade Commission has the authority to act on unfair or deceptive trade practices with respect to real estate sales, particularly as they relate to the marketing and selling activities of real estate companies.

Regulation Z of the Consumer Credit Protection Act

Since most real estate purchases are made on credit, truth-in-lending laws can have a significant effect on the operations of real estate financing transactions. Regulation Z of the Consumer Credit Protection Act prescribes requirements for both creditors and borrowers for full disclosure of credit costs and is applicable to all real estate transactions, regardless of amount, in which individual borrowers are involved in nonbusiness transactions.

Tax Matters

The Omnibus Budget Reconciliation Act (OBRA) of 1993 provides relief for real estate professionals by allowing them, for taxable years beginning in 1994, to offset net losses from rental real estate activities (that were previously treated as passive income losses) in which they materially participate against income from all sources. Material participation has the same meaning as under prior law. The most common method of achieving material participation in an activity is to work more than 500 hours in the activity in the taxable year. Other ways to achieve material participation in a rental real estate activity are (1) to perform substantially all of the participation in an activity, even if less than 100 hours, or (2) to have more than 100 hours of participation in the activity and more hours than anyone else. Limited partners, however, can only meet the material participation test for real estate through the 500-hour test.

Each hour of participation in a real property trade or business can count for all of the tests for relief under the new law. Real property trades or businesses that meet the requirements of these tests are defined as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental operation, management, leasing, or brokerage trade or business.

Audit Issues

Overall Risk Factors

Although conditions vary from entity to entity, the following are among the general factors inherent in the real estate industry that influence audit risk:

Magnitude and Complexity of Transactions. There is usually a large number of highly complex transactions.

Lengthy Development Period. Construction normally involves significant lead time. Delays may result in increased costs and create concerns about the net realizable values of assets.

Financing and Liquidity Concerns. Real estate operations are often highly leveraged, creating concerns about the ability of entities in the industry to continue to be able to obtain adequate capital and to meet their obligations as they become due.

Asset Valuation

In the current uncertain economic environment, impairment of assets continues to be a major concern throughout the real estate industry and a prime source of audit risk in audits of financial statements of real estate entities. Auditors should obtain reasonable assurance that management has considered all relevant factors in determining whether impairment has occurred. The subjectivity of determining the need for asset valuation allowances or write-downs, combined with continued economic uncertainty, reinforces the need for careful planning and execution of audit procedures in this area.

Lack of an asset impairment evaluation system or failure of a real estate enterprise to document adequately its criteria and methods for determining whether impairments have occurred may indicate a material weakness in the enterprise's internal control structure and will generally increase the extent of judgment that must be applied by auditors in evaluating the adequacy of management's allowances and write-downs and will increase the likelihood that differences will result. The AICPA Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information* provides guidance to help auditors understand real estate appraisal concepts and information.

Direct Investments in Real Estate Properties. Real estate held for investments should be reported at cost, less accumulated depreciation, and should be evaluated for impairment when facts and circumstances indicate that impairment may have occurred. In assessing the recoverability of recorded asset amounts for direct investments in real estate, auditors should be alert for conditions such as those described in the "Industry and Economic Developments" section of this alert. Auditors of publicly held companies should be particularly mindful of the comments of the SEC Observer in the Financial Accounting Standards Board's (FASB's) Emerging Issues Task Force (EITF) Issue No. 84-28, *Impairment of Long-Lived Assets;* if it is probable that estimated future cash flows will be less than the net carrying value of a property, a write-down is required. The SEC has indicated that it will also accept, but not require, measurement of impairment on a discounted basis. Recovery of previous write-downs is not permitted prior to their realization.

Real Estate Held for Sale. If it appears probable that an investment in real estate will be sold, the accounting principles applicable to real estate held for sale should be applied. Real estate held for sale (other than foreclosed real estate held for sale, which is discussed below) should be reported at the lower of cost or estimated net realizable value, using a valuation account to record declines in net realizable value from the carrying value on an individual property basis.

Foreclosed and In-Substance Foreclosed Real Estate. AICPA Statement of Position (SOP) 92-3, *Accounting for Foreclosed Assets,* provides guidance on measuring foreclosed assets and in-substance foreclosed assets after foreclosure. Under the SOP, there is a rebuttable presumption that foreclosed assets are held for sale. The SOP requires foreclosed assets held for sale to be carried at the lower of (1) fair value minus estimated costs to sell, or (2) cost. Foreclosed assets held for the production of income should be treated the same way they would be had they been acquired in a manner other than through foreclosure. The SOP refers to FASB Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* for its definition of fair value. In determining the appropriateness of fair values at which assets are presented in financial statements, auditors of publicly held entities should consider the guidance in Section 401.09 d of the SEC's Codification of Financial Reporting Policies, which indicates that the mere adoption of strategies such as a hold-for-the-future strategy based on expectations of future price increases, or a strategy of operating repossessed collateral on one's own behalf, cannot justify use of derived accounting valuations that portray results of operations more favorably than would use of current values in active markets.

Revenue Recognition

Current economic conditions may require auditors to carefully consider their clients' compliance with or changes in revenue recognition policies. Difficult economic circumstances may prompt some clients to change operating or accounting policies that affect the timing and propriety of revenue recognition. In evaluating the revenue recognition policies of clients in the real estate industry, auditors should carefully consider whether the criteria set forth in FASB Statement No. 66, *Accounting for Sales of Real Estate,* have been met. Auditors should carefully analyze the facts and circumstances surrounding property sales to be certain that there are no formal or informal put arrangements committing the seller, its officers, or its shareholders to repurchase the property, find other buyers, or indemnify the buyer or third-party guarantors for risk of loss. Auditors should also be alert for circumstances that indicate that a seller may have provided, directly or indirectly, the funds for a down payment or the entire purchase price in a cash sale. Such situations may create relationships that meet the definition of related parties as set forth in FASB Statement No. 57, *Related Party Disclosures.* SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards,* vol. 1, AU sec. 334), describes procedures that are designed to determine the existence of related parties as defined by FASB Statement No. 57.

Acquisition, Development, and Construction Arrangements

Lenders sometimes enter into real estate arrangements in which they take on virtually the same risks and potential rewards as those of owners or joint venturers. Guidance on determining the proper accounting for such arrangements is provided in AICPA Practice Bulletin 1, Exhibit I, *ADC Arrangements.*

Management's Discussion and Analysis—Public Companies

SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 550), requires that auditors read such information and consider whether the information, or the manner of its presentation, is materially inconsistent with that appearing in the financial statements. As auditors of real estate entities that are required to file reports with the SEC read the Management's Discussion and Analysis of Operations sections of SEC filings that contain audited financial statements, they might consider whether such discussions include items such as the following:

- Significant debt payments that will become due
- Capital requirements of planned development activities
- Trends in occupancy and rental rates
- Declining real estate values
- Changing interest rates
- Significant assumptions underlying estimates of net realizable value that are particularly sensitive to change

Entities with significant lending activities should provide information in a form substantially similar to that described in Sections III and IV of the SEC's Industry Guide 3.

Deferred Rent

The continued oversupply of rental space in certain areas of the country has resulted in a renter's market in which rent abatements and other enticements have become commonplace. FASB Statement No. 13, *Accounting for Leases,* requires that rents be recognized on a straight-line basis over the life of the lease even if payments are not made on a straight-line basis. Because of the number and magnitude of rent abatements being offered, significant deferred rent balances are sometimes recorded. In auditing such balances, auditors should carefully consider the reasonableness of assertions by management concerning the ability of tenants to continue to occupy the rental space in accordance with the lease agreement. If tenants are unable to occupy the space for the full term of the lease, deferred rents may not be fully recovered.

Availability of Funding

Real estate enterprises require substantial amounts of capital. In view of the sluggish state of the industry and as the result of large losses in the recent past, many of the traditional sources of capital for the industry have curtailed their support. Banks and savings institutions have reduced their real estate lending activity due in part to past experience and also because of the increased regulatory scrutiny to which real estate lending is subject. Severe economic conditions around the world have kept foreign investors from filling the gap.

SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards,* vol. 1, AU sec. 341), describes an auditor's obligation to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time as part of every audit. SAS No. 59 notes that although auditors are not required to perform procedures specifically designed to detect going-concern problems, information obtained from audit procedures planned and performed to achieve other audit objectives may identify conditions or events that cause the auditor to suspect there may be such problems.

Environmental Issues

The Environmental Protection Agency is empowered by law to seek recovery from any party that ever owned or operated a contaminated site, or anyone who ever generated or transported hazardous materials to a site. In view of the liabilities that may result from owning contaminated sites, virtually all real estate transactions entered into today give consideration to potential environmental liabilities. Auditors of real estate entities that face such claims should carefully evaluate whether the accounting and disclosure requirements of FASB Statement No. 5, *Accounting for Contingencies,* have been met. They should also be cognizant of the consensus reached by the FASB in EITF Issue No. 93-5, *Accounting for Environmental Liabilities,* that, among other things, an environmental liability should be evaluated independently from any potential recovery and that the loss arising from the recognition of an environmental liability should be reduced only when a claim for recovery is probable of realization.

Auditors of publicly held companies should also consider the requirements of SEC Staff Accounting Bulletin (SAB) No. 92, *Accounting and Disclosures Relating to Loss Contingencies,* which provides the SEC staff's interpretation of current accounting literature related to the following:

- Offsetting probable recoveries against probable contingent liabilities
- Recognition of liabilities for costs apportioned to other potential responsible parties
- Uncertainties in estimation of the extent of environmental or product liability
- The appropriate discount rate for environmental or product liabilities, if discounting is appropriate
- Accounting for exit costs
- Financial statement disclosures and disclosure of certain information outside the basic financial statements

Audit Risk Alert—1993 contains further discussion of these matters.

Accounting Developments

Impairment of a Loan

In May 1993, the FASB issued FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* which addresses the accounting by creditors for impairment of certain loans. The Statement is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller-balance homogeneous loans that are collectively valued for impairment, loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115, *Accounting for Certain Investments* *in Debt and Equity Securities.* It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms.

FASB Statement No. 114 requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral-dependent.

The Statement amends FASB Statement No. 5 to clarify that a creditor should evaluate the collectibility of both contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15 to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

The Statement applies to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

Some real estate companies may adopt the provisions of the Statement prior to its effective date. Auditors of the financial statements of such real estate companies should carefully consider the implications of applying the new provisions of the Statement on audit risk. Aspects of applying the new Statement that warrant particular consideration include—

- Proper identification of all loans to which the Statement should be applied.
- The reasonableness of estimates of cash flows and interest rates used in discounting.
- The appropriateness of amounts used to measure impairment if alternatives to present value amounts, such as fair values of collateral or observable market prices, are used.
- The presentation of accrued interest receivable and its relationship to valuation allowances.

Sources of guidance relevant to auditing loan loss allowances include SAS No. 57, *Auditing Accounting Estimates,* (AICPA, *Professional Standards,* vol. 1, AU sec. 342); SAS No. 11, *Using the Work of a Specialist* (AICPA, *Professional Standards,* vol. 1, AU sec. 336); and the Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks.*

Roll-Up Transactions

A growing number of real estate enterprises are engaging in roll-ups of real estate and other limited partnerships. Auditors of financial statements of publicly held entities engaging in such transactions should consider the guidance in SEC Financial Reporting Release 38, *Roll-Up*

Transactions, which requires heightened disclosure regarding fundamental changes and potential adverse effects arising from roll-up transactions as well as any conflicts of interest in, reasons for, alternatives to, and the fairness of such transactions. The release also calls for enhanced disclosures regarding valuation methods and additional pro forma financial statements. EITF Issue No. 87-21, *Change of Accounting Basis in Master Limited Partnership Transactions*, and SEC SAB No. 40, Topic 2 D, *Financial Statements of Oil and Gas Offers*, provide relevant guidance on the basis of accounting for the new entity.

* * * *

This Audit Risk Alert replaces *Real Estate Industry Developments—1992.*

* * * *

Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1993* and *Compilation and Review Alert—1993*, which may be obtained by calling the AICPA Order Department at the number below and asking for product number 022099 (audit) or 060666 (compilation and review).

Copies of AICPA publications referred to in this document may be obtained by calling the AICPA Order Department at (800) TO-AICPA. Copies of FASB publications referred to in this document can be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

022137