ACCOUNTING FOR REAL ESTATE

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This article is confined to accounting for real estate securities, that is, interests in real estate held through real estate investment companies. In the past the principal issuers of such securities have been (1) corporations whose principal activity is investment in real estate, (2) real estate investment trusts, and (3) real estate syndications, with one or more general partners selling limited partnership interests. Because of their importance in the development of real estate accounting the following issues are the focus of discussion: investor financial statement needs and differences between tax and financial accounting, investor needs for public reporting, the conflict between financial reporting for the real estate developer and the real estate investor, the depreciation-appreciation dilemma, and the accounting problems of projection presentation for real estate securities.

Investor Financial Statement Needs and Differences Between Tax and Financial Accounting

The investor financial statement needs for real estate syndications have for the most part been limited to annual tax return information, and quarterly and annual information as to sources and uses of each including income, financing, expenses, debt service, capital expenditures and distributions. Because of these limited needs, the accrual basis of accounting, such as required by generally accepted accounting principles, has not been required by typical investors in a real estate syndication, and because the accrual method is not necessary for tax purposes, tax and financial reporting in many cases have been on the same basis. Thus independent public accountants have developed reports which render opinions only on the manner of accounting used.[1] It can be presumed, however, that the investors have wished to be informed by disclosure whenever accrual adjustments for accounts receivable and payable and accrued liabilities varied from accruals that would arise solely from month-to-month typical trade and payment terms, that is, when liabilities, particularly debt service, were delinquent or revenues were delinquent in collection beyond usual experience.

Where public trading or wide ownership is expected (for corpora-

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[1] AICPA, COMMITTEE ON AUDITING PROCEDURES, STATEMENTS ON AUDITING PROCEDURE NO. 33, AUDITING STANDARDS AND PROCEDURES, ch. 13 (1963). AICPA, STATEMENT ON AUDITING STANDARDS § 620.05 (1973).

tions, real estate investment trusts, and some real estate syndications), the need for financial reporting to the participants or shareholders in conformity with generally accepted accounting principles (whatever their deficiencies in fairly reporting financial position and results of operations) clearly has been imposed. A product of this need has been what is referred to as "two sets of books" since tax reporting seldom is wholly in conformity with generally accepted accounting principles.

The most common accounting difference is the use of the cash basis of accounting for tax purposes as permitted by the Internal Revenue Code[2] while using the accrual method of accounting for financial reporting purposes as required by generally accepted accounting principles.[3] The essential difference in the two methods of accounting is that accounts receivable and prepayments and accounts payable and other accrued liabilities are not reported under the cash basis.

The cash method is commonly used for tax reporting purposes because of its inherent flexibility as to choice of taxable year for reporting revenues and expenses—particularly with respect to prepaid expenses—by control of cash receipts and disbursements. This shifting of revenues and expenses from one year to another is subject to limitations of distortion. For example, in response to abuses arising from the deduction of prepaid interest, the Internal Revenue Service has taken the position that the cash method taxpayer who pays interest in advance for a period extending more than twelve months beyond the end of his current tax year must deduct this amount ratably over the tax years involved.[4] Interest paid in advance for a period not in excess of twelve months following the end of the current tax year may be deducted by a cash method taxpayer in the year paid, if the deduction does not give rise to a material distortion of income. In addition, certain items such as sales and purchases of inventory, depreciation, and bad debts are reported on an accrual rather than a pure cash basis. Hybrid methods, that is, part cash-part accrual, may be used if they fairly reflect income for tax purposes.[5] Whatever method is chosen as being most representative of income for the reporting entity, the method used for tax purposes should be recorded on the books.[6]

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[2] INT. REV. CODE OF 1954, § 446(c)(1). [Hereinafter cited as CODE].

[3] ACCOUNTING PRINCIPLES BOARD, STATEMENT NO. 4, BASIC CONCEPTS AND ACCOUNTING PRINCIPLES UNDERLYING FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES, para. 35 and 121 (1970).

[4] Rev. Rul. 68-643, 1968-2 CUM. BULL. 76.

[5] CODE, § 446(c).

[6] CODE, § 446(a).

Another important difference is the ability to utilize installment gain reporting for tax purposes, although generally accepted accounting principles discourage its use unless realization problems are present.[7] Currently, the best guidance for the use of the installment method of accounting for financial reporting purposes may be found in two American Institute of Certified Public Accountants accounting guides.[8] For tax purposes, a sale of real property with no payments in the year of sale, or payments aggregating 30% or less of the selling price (adjusted for imputed interest, if necessary) in the year of sale, may permit individual election as to the use of the installment method. In most cases, payments of from 10% to 25% of the sales value would cause the sale to be recorded on a full recognition basis for financial reporting under generally accepted accounting principles even though the sale might be treated as an installment sale for tax purposes.

Other statutory elections are permissible for tax purposes with respect to interest, taxes, and certain other carrying charges. The taxpayer may elect to expense or capitalize these costs for tax purposes either by year for land parcels or by project for development projects.[9] For financial reporting, these costs must be consistently treated one way or the other, with the major support favoring a practice of capitalizing the costs, subject to limitations of realizability in the sale or development.[10]

For depreciation charges, statutory elections for tax purposes may permit the straight-line method or one of several accelerated methods, subject to certain restrictions relating to depreciable real estate.[11] New commercial real estate may not be depreciated at rates faster than the 150 percent declining balance method; only the straight-line method is available for used commercial real estate. Residential rental property, however, qualifies for faster rates. New residential rental property may use the double declining balance and used residential rental property may use the 125 percent declining balance. For financial reporting, however, depreciation may be on a straight-line basis; under full payout, net lease circumstances, the annuity method; or any rational method that fairly

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7 AICPA, ACCOUNTING PRINCIPLES BOARD, OPINION NO. 10, OMNIBUS OPINION, para. 12 (1966).

8 AICPA, COMMITTEE ON LAND DEVELOPMENT COMPANIES, ACCOUNTING FOR RETAIL LAND SALES 6-9 (1973); AICPA, COMMITTEE ON ACCOUNTING FOR REAL ESTATE TRANSACTIONS, ACCOUNTING FOR PROFIT RECOGNITION ON SALES OF REAL ESTATE, paras. 8, 34 (1973).

9 CODE, § 266; Treas. Reg. § 1.266-1 (1959).

10 AICPA, COMMITTEE ON LAND DEVELOPMENT COMPANIES, *supra* note 8, at para. 51.

11 CODE § 167(j).

presents income, including accelerated methods of different types.[12] The methods elected for tax purposes do not have to agree with the methods chosen as being most appropriate under generally accepted accounting principles. These financial reporting requirements for depreciation are frequently attacked as unrealistic for income reporting of real estate investments under generally accepted accounting principles; on the other hand, the accelerated methods for tax purposes are zealously defended by investors.

Particularly now that the new accounting guidelines as to completion of the earnings process have been issued by the AICPA,[13] income recognition may be slower for financial reporting than for tax purposes. This slower income recognition pattern has been the case to some extent in the past. For example, in sale/leaseback transactions, for financial reporting, gains are deferred for recognition over the period of the lease;[14] they are recognizable for tax purposes upon sale unless the leaseback period is so long or repurchase options so favorable as to cause the Internal Revenue Service to construe the transaction as a loan.[15]

There is good logic for a difference in accounting. The basic purpose of the tax law is to raise revenue in a fair manner and, by application, to provide incentives for investment in areas Congress believes to be in the public interest. The purpose of financial reporting, however, is to provide financial information for decisions by management, creditors, investors and others with interests of one kind or another in the business.

The considerable variance in accounting practices in the area of real estate investment, however, has been part of the reason for a significant credibility problem that has plagued real estate investment and development reporting for fifty years or more. Part of the reason for this credibility problem has been the failure of accounting to reflect what many people believe to be the real economics of the business and the economic results of its operations. Generally accepted accounting principles developed around the short turnover working cycle of a commercial business as it existed some generations ago, and admittedly, these principles produce financial results that only infrequently report the real changes in economic values. Thus a disparity arose between what most people want

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[12] AICPA, COMMITTEE ON ACCOUNTING PROCEDURE, ACCOUNTING RESEARCH BULLETIN NO. 43, ch. 9C, para. 5.

[13] AICPA, COMMITTEE ON LAND DEVELOPMENT COMPANIES and COMMITTEE ON ACCOUNTING FOR REAL ESTATE TRANSACTIONS, *supra* note 8.

[14] AICPA, ACCOUNTING PRINCIPLES BOARD, OPINION NO. 5, REPORTING OF LEASES IN FINANCIAL STATEMENTS OF LESSEE paras. 19-22 (1964).

[15] CODE, § 1031; Treas. Reg. § 1.1031(a)-1(c) (1956).

in the way of reporting on the results of real estate operations and what actually is reportable. As a result, many managers employed imaginative accounting to bend the principles to the point where they broke.

Some undesirable results have emanated from the inability of many to cope with the extreme complexity of the analytical requirements imposed by this accounting quagmire. For example:

(1) Real estate securities that probably should have sold have proved difficult to sell.

(2) Real estate securities which are more "gimmicks" than investments have proved too easy to sell.

(3) The AICPA, which was then responsible for establishment of accounting principles, was forced to issue, in much haste, badly overdue guidelines. These did not correct the failure of the accounting model to provide useful information, but merely rewove the fabric of existing realization principles to attempt to put an end to the recording of unrealized profits.

(4) Most dismally, however, these accounting failures may have actually caused bad management decisions aimed at attempting to report favorably on operations at considerable economic cost to investors.

As an example, a real estate investment trust seldom takes accelerated depreciation on real estate because the operation of the tax laws would cause its shareholders exposure to double taxation on return of capital distribution and sale of property.[16] The trusts, however, have trouble competing in the marketplace for investors' funds without making such distributions since they have reduced earnings to report; they may not report distributable cash on a per share basis[17] (the only basis probably understandable to the average real estate security investor); and generally, therefore, they pay cash to demonstrate what they have actually accomplished. (Even here, there is a large question whether such distributions are economically a return of capital, a matter that is not finally determined until disposition of the property). Thus one of the most valuable attributes of property, availability of accelerated depreciation and tax deferral, which is inherently related to it, is dissipated with no compensation.

One positive step the Securities and Exchange Commission [SEC] has taken is to require reporting of the major differences between taxable income and financial income.[18] Although the objections to this were

[16] CODE, § 312(m) (effect of accelerated depreciation on earnings and profits); §§ 56-58 (minimum tax), § 1250 (gain from disposition of certain depreciable reality).

[17] SEC Accounting Series Release No. 142 (Mar. 15, 1973).

[18] SEC Accounting Series Release No. 149 (Nov. 28, 1973).

considerable, a better disclosure of the specific reasons actually should have considerable analytical benefit and make financial accounting more credible by reason of increased understanding.

Inherent Investor Needs for Public Reporting

As noted above the untraded investment carries with it a relatively low level of investor needs: his share of distributable income or loss items for his tax return; a fair reporting of operating income and expense on the tax return method of accounting and cash flow information and a related "tax" balance sheet so that he may be satisfied with the stewardship as to his investment; and information as to pending problems such as delinquencies in receipts and payments, claims by others and so forth which could adversely affect his investment.

Where initial offerings of real estate are being made, however, the potential investor requires additional information with which to evaluate the effect his investment would have on his personal tax and financial position. This would require, at a minimum, two levels of pro forma information:

(1) *Positive level*—distributable cash expected from operations and from disposition of the property and distributable taxable income or loss if the investment works out as planned by the issuer.

(2) *Negative level*—cash requirements for maintaining debt service, their source if cash from operations is insufficient to service debt, and distributable tax profit (the "exit penalty") if the property is permitted to revert to the lender at various times in the future through default on the payment of indebtedness. The "exit penalty" is the term given to the taxable income that is reportable where property has been depreciated below the balance of indebtedness relating to the property that is extinguished when the property is allowed to revert to the lender. Most real estate syndications have been built on a concept of providing tax deductions to the investor in excess of the investor's contribution of capital through the assignment of tax bases to the investor interest attributable to nonrecourse financing of the property.

Historical results of operations with pro forma adjustments provide the basis for this type of information where operating properties with a history are being offered, but only projections can suffice with respect to properties without operating history.

"Blind pools" continue to present a problem since it is difficult to project the unknown property; however, information about the sponsor's similar activities would seem appropriate, including the information that he has not had any similar activities if that is the case. Some suggestions have been made that expectations of the impact on investors of meeting the investment objectives of the syndication might be useful, such as the distributable cash and distributable taxable income or loss that is contemplated to be achieved from the investment objectives. It is important, if this ultimately evolves as a requirement by securities regulators, that due consideration also be given to providing the negative level of pro forma possibilities if the investment objectives are not attained. Similarly, it would appear that the investment objectives should cover the matter of anticipated financing and its effect upon break-even levels with respect to cash requirements within the partnership.

Where offerings involve guarantees or implied support of the promoter, or adequate investment by the general partner to provide a "safe harbor," the investor also needs information as to the financial position and the results of operations of the promoter and the general partners.

Where the securities to be offered are expected to be traded or where holdings are widely disseminated to less sophisticated investors, the investor information needs are much more sophisticated. They would include, for instance, current information as to financial position, results of operations, and changes in financial position reported in conformity with generally accepted accounting principles. Because of the limitations of usefulness of financial statements prepared on the basis of generally accepted accounting principles, particularly as to reporting results of operations of real estate investments, the reporting of the changes in financial position including the funds derived from operations of the property assumes much greater importance. Indeed, to evaluate his interests, the investor really needs to know the funds available from operations and dispositions of property for distribution or re-investment with respect to his pro rata interest, that is, per share or per unit, a piece of information now precluded in SEC regulated securities.[19]

Unfortunately, one of the most important needs for the unsophisticated investor also cannot be provided—the fair market value of his interest in the properties. Unlike other regulated investment companies where the rules require market value information,[20] the real estate investment company is precluded by practice from providing this information. (Oddly, no citation of authority is possible here. It is related to Principle E-2[21] which states "increases in assets rarely arise from external

[19] *Id.*

[20] SEC Regulation S-X, Rule 6-02(b) "Valuation of Assets," 17 C.F.R. § 210.6-02(b) (1973).

[21] AICPA, ACCOUNTING PRINCIPLES BOARD, STATEMENT NO. 4, BASIC CONCEPTS AND

events other than transfers"—in other words, on the transactional orientation of the accounting model). The result of this lack of information is that the investor is required either to ignore the problem, to try to develop his own estimates from inadequate information or to use other overall analytical evaluation techniques of doubtful result such as cash distribution valuation, which is the predominant method used by securities analysts.

The solution to his analytical need is to require valuation in reporting for real estate securities under some kind of expertizing with liability, or as an alternative, adequate reporting of information with respect to operations of individual properties to provide a suitable basis for investor evaluation. This latter approach is somewhat likely to fall of its own weight if only because of the vast amount of detail to be evaluated if the entity holds a sizeable portfolio of properties.

Conflict Between Financial Reporting for the Real Estate Developer and Real Estate Investor

Because the investor had so little knowledge of real estate investment and risk, he tended to want as riskless an investment as he could negotiate (or, at least, what he thought was riskless). This resulted in the developer agreeing to transactions frequently involving one or both of the following characteristics: (1) minimum cash investment by the investor and settlement of the balance due the developer out of cash generated by operations of the property and tax "savings" of the purchaser, or (2) continuing involvement by the developer for various periods in providing cash to meet deficits in cash requirements, provide guaranteed return to the investor, develop the property for the investor, and protect the investment in other ways.

Similarly, some developers tried to be both developers and investors for their shareholders. This dual role required imaginative accounting to provide reportable income per share; alternatively, the developer entity had to try to carry a message of "cash flow" per share as being the significant analytical tool in lieu of earnings per share when talking to analysts and investors.

The SEC responded to this message by issuing accounting series releases to attempt to stop the possibly misleading presentations that arose and to proscribe reporting "cash flow per share" or similar information to investors. The AICPA reacted by issuing two accounting guides to attempt to put income and profit-recognition reporting for

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ACCOUNTING PRINCIPLES UNDERLYING FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES para. 187 (1970).

land development companies and real estate developers and investors back into the framework of realization principles under generally accepted accounting principles.

Accounting Series Release No. 95[22] lists nine circumstances which tend to raise a question as to the propriety of current recognition of profit: (1) evidence of financial weakness of the purchaser; (2) substantial uncertainty as to amounts of costs and expenses to be incurred; (3) substantial uncertainty as to amount of proceeds to be realized because of the form of consideration or method of settlement; (4) retention of effective control of the property by the seller; (5) limitations and restrictions on the purchaser's profits and on the development or disposition of the property; (6) simultaneous sale and repurchase by the same or affiliated interests; (7) concurrent loans to purchasers; (8) small or no down payment; and (9) simultaneous sale and leaseback of property.

The objective of ASR No. 95 was not achieved since it tried to solve the problem by describing a variety of factual circumstances, a combination of which created profit recognition problems, without describing the thrust of the principles included and the accounting practices that could be followed if these limiting circumstances existed.

Accounting Series Release No. 142[23] proscribes reporting "cash flow per share" or similar information to investors on the ground that cash flow data is not a substitute for or an improvement upon properly determined net income as a measure of results of operations.

The AICPA guides[24] tried to attack the matter by addressing two principal issues:

(1) Levels of initial cash investment and continuing cash investment by the buyer necessary to result in a receivable of enough liquidity and measureability to support use of the accrual (realization) process. The guides further specify methods of accounting that might appropriately be used if the levels of cash investment were initially (or on a continuing basis) insufficient for total profit recognition at the time of the initial transaction.

(2) Completion of the earnings process (the other element of the realization principles), that is, the transference of the risks of ownership and the completion of the seller's performance obligation to the buyer. Once again, specified accounting was recommended where this

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22 SEC Accounting Series Release No. 95 (Dec. 28, 1962).

23 SEC Accounting Series Release No. 142 (Mar. 15, 1973).

24 AICPA, COMMITTEE ON LAND DEVELOPMENT COMPANIES and COMMITTEE ON ACCOUNTING FOR REAL ESTATE TRANSACTIONS, *supra* note 8.

either occurs at a single point in the future or progressively as performance takes place in the future.

All these guidelines will affect real estate developer securities. Their impact on real estate investment securities will be to limit the type of transactions negotiable in acquisition of real estate and, for the real estate investment entity, limit its reporting of profits from disposition of property. Where the financial statements of the developer are required in the issuance of investment securities, these statements may be affected and thus indirectly affect the issuer. It would appear that these changes will do little to promote the use of the developer-owner type of entity since realization of income will occur only slowly from operations and ultimate sale of property.

Depreciation/Appreciation Dilemma

Turning to the depreciation issue, one finds that operators of real estate frequently do not discuss depreciation as being an economic charge against earnings, and many question whether depreciation of real property is a proper expense in determination of income from real property. The value of any property, tangible or intangible, personal or real, is the present value of the stream of income (or net cash proceeds) that can be derived from it. The present value is determined by discounting this income stream at the buyer's anticipated rate of return on investment.

Conventional straight-line depreciation (a concept of cost allocation, not value representation), therefore, actually anticipates a *declining* level of income. For example, using a 10-year anticipated income life, with no salvage value, the straight-line allocation of cost, using a 10% return assumption and a $100,000 investment, is rational only if net cash from operations follows the approximate pattern below:

Period	Cost Recovery (Depreciation)	Return @ 10%/Annum	Net Cash After Operating Expenses
1	$10,000	$10,000	$20,000
2	10,000	9,000	19,000
3	10,000	8,000	18,000
4	10,000	7,000	17,000
5	10,000	6,000	16,000
6	10,000	5,000	15,000
7	10,000	4,000	14,000
8	10,000	3,000	13,000
9	10,000	2,000	12,000
10	10,000	1,000	11,000

Alternatively, if the income expectation is straight-line, the rational depreciation (cost allocation) pattern is an annuity pattern. Using the same investment as in the prior example but straight-line income:

Period	Cost Recovery (Depreciation)	Return @ 10%/Annum	Net Cash After Operating Expenses
1	$ 6,275	$10,000	$16,275
2	6,903	9,372	16,275
3	7,593	8,682	16,275
4	8,352	7,923	16,275
5	9,187	7,088	16,275
6	10,106	6,169	16,275
7	11,117	5,158	16,275
8	12,228	4,047	16,275
9	13,451	2,824	16,275
10	14,788	1,487	16,275

These are overly simplified examples, and the rationale for them has been defined as an investor's level return on investment, but the point is that real estate depreciation rationally follows the annuity pattern *only* if income is straight-line. Income from real estate would more nearly follow declining patterns (except for net leases) were it not for inflation in *values*. That is, physical deterioration and increasing maintenance plus obsolescence would take their toll were it not for inflation in costs (thus increasing replacement cost) and limited land availability in a comparable location both of which *may* serve to keep net rentals from declining or even cause them to increase. The evidence of this may be observed from certain economic realities: (1) eventually, property improvements finally deteriorate to the point where they must be replaced; (2) in developments where the locational advantage is lost, values may decline, not rise, with a resulting impairment of rental capability; and (3) where developments are rendered obsolete through design, new materials, and so forth, they no longer compete as effectively for rentals.

A fair conclusion to be drawn from this evidence is that real estate probably does depreciate on a pattern more nearly approximating the straight-line pattern, but *unrealized* appreciation of the improvements (through cost inflation) and land values (through locational demands) is frequently taking place at the same time.

If depreciation permitted for tax purposes did not include at least the straight-line method of depreciation, inequitable or unfair taxation would result. That is, the taxing authorities would be taxing *unrealized* appreciation of values if they allowed deductions only on a pattern that permitted recovery of cost more slowly than recovery under the straight-line method. Furthermore, the fairness of depreciation deductions recaptured at ordinary rates, except for accelerated deductions, is highly questionable. The present Internal Revenue Code recognizes this[25] although many critics continue to assert that investors obtain an extraordinary tax benefit from depreciation deductions.

This analysis also indicates that financial income reporting utilizing straight-line depreciation of real estate improvements is not a reporting deficiency under generally accepted accounting principles of realization; *it is a matter of the reporting process ignoring economic facts of appreciation of value (and, at times. the loss of value).*

The present inability of the accounting process to fairly reflect economic facts, aided and abetted by a proscription of value information in financial reporting, has had unfortunate ramifications:

(1) It continues to generate unwarranted discussions of tax reform with respect to depreciation practices for real estate.

(2) It has inhibited real estate development for ownership rather than sale by inhibiting access to equity money in the public securities markets.

(3) It has caused offerings of interests in real estate to be made to unsophisticated investors on the basis of inadequate information and at such a high level of front-end selling costs that it becomes highly questionable whether the value of the property is as high as the initial offering price.

(4) It may well have caused the real estate development industry to create more product than the market warranted.

(5) It has caused a possibility of misdirection of investors through arrangements that disguise equity ownership by use of land leases, high loan-to-value ratio loans and other techniques that try to accomplish an income reporting pattern that follows the economic facts *even though that reporting does not disclose that much of the income is unrealized appreciation.*

Accounting Problems of Projection Presentation for Real Estate Securities

One of the more knotty problems in real estate reporting is projection presentation. Actually, no accounting problems in presentation of projections exist. The conversion of assumptions into a financial presentation is a mathematical exercise that can be performed by anyone with a limited mathematical ability or a computer with a properly designed program. Classifications and presentations can be prescribed by forms by the regulators, and the application of generally accepted ac-

[25] CODE, § 1250.

counting principles to the information can be based upon the method of accounting to be used. Furthermore, the required assumptions are most likely best prescribed by the regulators.

The problem with respect to projection information in real estate or any other business activity always has been, and always will be, with the assumptions utilized in the projections. As with any issue that deals with the future, there is no way of knowing, short of guarantees by third parties, that results will be as projected. Certain matters such as tax results can be judged based on present knowledge, but they will ultimately be determined by third parties who may be able to change the rules. Furthermore, an offeror's projections will probably have an optimistic bias or the offering might not be practicable; therefore, more realistic projections will likely produce satisfactory results only by edict from regulators.

In the past, the independent public accountant's association with projections has been by disclaimer,[26] that is, his report has said that the projections have been prepared to reflect the assumptions and estimates, but since they relate to the future, he cannot express an opinion on them or on how closely the projections may approximate the actual results.

The accounting profession has a credibility crisis arising primarily out of the belief that accounting is a more exact science than it is and a lack of recognition that accounting is merely a communication system built upon a considerable level of judgment. This raises a real question whether it is appropriate for regulators and the public to ask the accounting profession to be associated with projections which are *very likely* to be based on assumptions that will not be achieved. Furthermore, considering that projections involve professional work by the independent public accountant only if he assumes some responsibility for the assumptions, the key question is whether he really is the best qualified to undertake the responsibility. A higher level of economic forecast expertise exists outside the accounting profession than within it. In fact, much of the profession's credibility problem on historical financial statements lies in its inability to anticipate the impact of the future on the historical statements, that is, asset valuation and reserves, or if not its inability to anticipate that impact, its inability to impose its opinion on that of its client.

Present proposals on the question of the independent public accountant's association with forecasts suggest an opinion somewhat along these

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[26] AICPA, RESTATEMENT OF THE CODE OF PROFESSIONAL ETHICS 1972, Rule 2.04—Forecasts: "A member shall not permit his name to be used in conjunction with any forecast of future transactions in a manner which may lead to the belief that the member vouches for the achievability of the forecast."

lines: (1) that the compilation agrees with the assumptions; (2) that the presentation is in conformity with generally accepted accounting principles; and (3) *that the assumptions are not unreasonable.* There is some delay in coming up with the definition of standards for determination of whether the assumptions are reasonable or not reasonable.

Another problem may exist if the accountant is to be associated with projections: Can the historical position of independence of the accounting profession be maintained if the firm associated with the projections is held to a financial responsibility with respect to assumptions, as well as for later opinions with respect to the actual results of operations, when the results may indict the initial assumptions? History indicates there is a significant problem of the proper application of independent judgment in reporting actual results of operations after projections have been publicly disseminated with respect to projected or anticipated results.

Accounting involves many judgments to be made in the process of trying to isolate income and related charges against income to accounting periods, particularly with respect to business cycles which for real estate may run out to the total life of real property. These judgments affect such matters as the method and life assumptions for allocation of charges for depreciation, reserves for collection losses on receivables, valuation of liabilities paid over a long period of time, overhead capitalization policies, obsolescence, and capitalization of carrying charges. These judgments often have a significant impact on the reported results of operations for any single fiscal period and on the financial position of a business entity.

The independent public accountant exercises his judgment with respect to these questions based upon examination of certain documentary evidence and application of knowledge of general economic conditions and their possible impact to be recognized in an accounting period. Similarly, management of the entity, which has primary responsibility for the financial statements, also makes its judgments, probably from an even better position of being able to evaluate the impact of external circumstances upon the internal affairs of the business. Nonetheless, in the usual process of financial reporting by management and examination and reporting by independent public accountants, differences of opinion arise with respect to these judgments and they are resolved in an atmosphere fairly free of undue bias with respect to the results of the decisions on the financial statements. Once the chief executive officer or the chief financial officer has given information with respect to expected results of operations, however, particularly on a per share basis, a significant bias is injected into the resolution of differences of judgment.

The later judgments of management will be influenced by the desire on their part to achieve performance relatively close to that predicted. This bias causes the judgments to be made either favorably or unfavorably to reported income as required to keep it within the area of projection.

While the independent public accountant may keep the effect of this bias within bounds of reason on an annual basis, the small increments of optimistic bias reflected in financial reporting often accumulate into a difficult problem sometime in the future after several reporting periods. The result of this has been what is frequently described as "big bath" accounting. In a period when operating results are unfavorable, management takes the opportunity to clear the balance sheet of deferred charges or unrecoverable or doubtful values so that they will no longer constitute an impediment against the future. This will be an even greater problem if the optimistic bias is now to be shared by the independent public accountant who reports on the projections and later examines the financial statements reflecting actual results of operations.

The propensity for some investments to fail to meet expectations imposes a high degree of necessity for adverse as well as favorable projection information. This adverse information would include break-even analysis, for example, at what level of rentals or excess expenses would the cash generated be inadequate to service debt. A further type of adverse information would be full exhibition of economic and tax effects of foreclosure or relinquishment of the property at various points of time in the future.

If third party expertizing on projections is considered desirable, it would be appropriate to look to real estate economists and appraisers, not the accounting profession. Even in these professional groups present standards are probably not adequate as a basis for expertizing in securities offerings.

Finally, if the regulators consider it expedient to involve the accounting profession, they should satisfy themselves that the profession has established adequate standards for performance to reduce the discrepancy between the profession's achievement and the expectations that the regulators, and the public, will have with respect to the profession's performance. Furthermore, considerable study is required to determine if the accounting profession has within its membership the competence to expertize on projections and, if it does, how this competence may be evaluated with respect to any given practitioner.

Considering the difficulties of getting satisfactory expertizing, perhaps the first step should limit any presentation to the offeror's projections, both favorable and unfavorable, and the assumptions used, and permit the marketplace to assess the weight to be accorded to them. This was the conclusion of the Financial Analysts Federation research project on corporate forecasts.[27]

It would be desirable for those involved in the decisions in this area to be mindful of a few matters with respect to projections, specifically:

(1) Any forecast will be wrong, inevitably.

(2) The degree of wrongness in the forecast and the resulting consequences will depend on many factors, not the least of which is luck.

(3) A wrong forecast may well lead to a bad decision—at least one that results in an unsatisfactory investment when compared with expectations. The degree of wrongness and dissatisfaction similarly depend on many things, not the least of which is luck.

(4) A dissatisfied investor turns increasingly to litigation for recovery and he is unwilling to admit that it is his ultimate responsibility to make the forecast on which he makes his decision—that is the risk-taker's function in investment markets. Consequently, projection information in offerings might well be accompanied by clear indications that the information is being provided only for the use of the prospective investor in *making his projection as to future possibilities*, etc., and that it does not represent any indication of what actual results may be.

Summary of Accounting Requirements in Security Regulation

Smaller non-traded offerings that do not require continuing Securities and Exchange Commission reporting have generally been satisfactorily reported upon with tax-reporting-oriented statements with satisfactory disclosures. The SEC offerings and traded securities, including real estate investment trusts and real estate corporations, have been required to use financial statements prepared in conformity with generally accepted accounting principles. Many issuers have recognized that application of these principles does not fairly reflect the results of real estate operations. Their remedy often has been to use accounting that departed significantly from what accountants believed were appropriate principles. This resulted in publication of:

(1) Accounting Series Release No. 95 by the SEC,

(2) Accounting Guide "Accounting for Retail Land Sales" by the AICPA,

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[27] Steward, *Research Report on Corporate Forecasts*, 29 FINANCIAL ANALYSTS JOURNAL 77, 85 (1973).

(3) Accounting Guide "Accounting for Profit Recognition on Sales of Real Estate" by the AICPA.

Some investment-oriented companies, unable to present value information, have attempted to overcome the problem by expressing results of operations as "cash flow per share", "income before depreciation" or some variant without common definition to give what they believe to be more representative per share results, or they have been forced to pay dividends out of capital with the following results:

(1) Accounting Series Release No. 142 by the SEC,

(2) Industry efforts to arrive at common definitions of funds available for distribution or reinvestment so that useful comparable information may be provided investors.

Other investment-oriented companies and mortgage trusts have begun to invest in land leases, high loan-to-value loans and other methods of structuring investments aimed at avoiding depreciation charges against income. This may cause a new round of credibility problems since it may create liquidity problems and losses if depreciation is not adequately offset by appreciation. Some attention is being given to recognition of fee income, but this may only be the tip of the iceberg.

Some projections of operating results have been required or permitted in real estate offerings, but such projections need a new discipline to fairly present to the investor the possibilities of unsatisfactory performance in his investment. The use of projections is also difficult for "blind pool" types of offerings.

The real need for investor reporting is the clear presentation of satisfactorily expertized value information subject to suitable standards and the fair presentation of unrealized gains or losses. This approach, however, has not been adequately studied. If a suitable basis for this type of reporting could be developed, realization principles for income recognition could be maintained on a strict basis, with the result that credibility would return to this industry and investment decisions would be based upon inherent economic considerations.