Impairment Consideration for Real Estate Investors

One of the most difficult areas of real estate accounting is making a determination regarding whether real estate asset values are overstated, and as a result, whether a write down to fair value is necessary. Making this determination involves a number of factors, including estimates of future economic conditions, the effects of geographic concentration, governmental and political factors and professional judgment, to name a few. In an industry where tax consequences are often a driver in decision making, the financial statement reporting requirements for performing impairment analyses can often be a difficult concept to wrap your head around. Impairment occurs when an asset's carrying value (the value at which it is recorded on an organization's balance sheet) is greater than its fair value. The best way to approach an impairment analysis is to simply break it down step by step.

The first item to consider is whether the real estate asset is to be disposed of by sale or held for use. If an asset is to be disposed of by any means other than its sale, impairment considerations should be based on facts and circumstances as if the asset were to be held for use.

For assets to be disposed of by sale:
According to FASB Accounting Standards Codification (ASC) 360, long-lived assets may only be classified as held for sale if all of the following criteria are met:

- Management, with appropriate authority, commits to a plan to sell the asset;
- The asset is available for immediate sale in its present condition subject only to usual and customary terms;
- Actions required to complete the plan to sell have been initiated, and it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn;
- The asset's sale is probable and expected to occur within one year;
- The asset is being actively marketed for sale at a price that is reasonably comparable to its current fair value.

If the above qualifications are met and assets are to be disposed of by sale, the assets are required to be stated at the lower of the carrying value or fair value adjusted for costs to sell the asset. Fair value is defined by FASB ASC 820 as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Various valuation methods are available for making a determination of fair value. Once the fair value and selling costs have been determined, the fair value less selling costs should be compared to the carrying value. If the fair value is less than the amount at which the asset is being carried on the balance sheet, impairment has occurred and the asset should be written down to its fair value. If the fair value subsequently decreases further, the carrying value should be further reduced. If the fair value subsequently increases, the adjusted carrying value may be increased to reflect the new fair value, but in no event in an amount greater than its cost basis. It is an industry best practice to assess assets to be disposed of by sale at least annually and as close to the balance sheet date as reasonably possible.
For assets to be held for use or disposed of by means other than sale:
If the real estate asset is either held for use or to be disposed of by any means other than sale (classification subject to the guidelines above), impairment should only be recognized with a write down of the carrying value if the decline in value is not considered recoverable. An impairment analysis of real estate assets held for use is only required to be done if events have occurred or conditions are present which indicate that the asset may be impaired. FASB ASC 360-10-35-21 identifies the following events and/or conditions which may indicate that a real estate asset is impaired:

- A significant decrease in the market price;
- A significant adverse change in the extent or manner in which the asset is being used or in its physical condition;
- A significant adverse change in legal factors or in the business climate that could affect the value of the asset, including an adverse action or assessment by a regulator;
- An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of the asset;
- A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses;
- A current expectation that, more likely than not (greater than 50% chance), an asset will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

If management determines that conditions are present which may indicate that impairment has occurred, a "recoverability test" should be performed. To perform this test, management should compare the expected future net cash flows (including those from its eventual disposition) they expect to receive from the asset to the amount at which the asset is being carried on the balance sheet. If the expected future cash flows are less than the carrying amount, the decrease in value is not considered recoverable and impairment has occurred.

Once a determination has been made that an asset is impaired, management must measure the impairment loss. To do this management should compare the fair value of the asset to the carrying amount. The amount by which the carrying amount exceeds the fair value should be recognized in current year operating income as an impairment loss. Going forward, the asset should be depreciated based on its new cost basis. Contrary to the treatment of impairment on assets held for sale, the carrying value is not permitted to be increased for future increases in fair value.

The relevance of real estate asset impairment has increased in recent years due to economic conditions. Many companies have experienced circumstances over the past few years which may indicate that their real estate holdings are impaired. Approaching the impairment analysis does not need to be a daunting task. Separating the considerations into their component parts and approaching it one step at a time will help to simplify the process and improve the quality of the analysis. Finding the right financial model to use in order to determine fair value can be another challenge in this process. In forthcoming articles, we will highlight some of the most commonly used approaches. As always, your Dixon Hughes Goodman advisors are standing by to answer questions and help you through such an analysis.

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