

Statement of Financial Accounting Standards No. 41

Note: This Statement has been completely superseded

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Financial Reporting and Changing Prices:
Specialized Assets—Income-Producing Real Estate

(a supplement to FASB Statement No. 33)

November 1980



Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

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a supplement to FASB Statement No. 33

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FAS 41: Financial Reporting and Changing Prices: Specialized Assets—Income-Producing Real Estate

a supplement to FASB Statement No. 33

FAS 41 Summary

This Statement supplements FASB Statement No. 33, *Financial Reporting and Changing Prices*. It requires enterprises that present information on a current cost basis to combine measures of income-producing real estate and related expenses at either historical cost/constant dollar amounts or at current cost amounts with current cost measures of other assets and expenses. Statement 33 provides that an enterprise need not present information on a current cost basis if there would be no material difference between that information and information on a historical cost/constant dollar basis. Therefore, an enterprise needs to present information on a current cost basis only if it has significant holdings of inventory, property, plant, and equipment apart from income-producing real estate. This Statement applies to fiscal years ended on or after December 25, 1980.

The Board will continue to work with its advisory task group for the real estate industry to develop improved methods of measuring the effects of changing prices on this industry.

INTRODUCTION

1. FASB Statement No. 33, *Financial Reporting and Changing Prices*, establishes standards for reporting certain effects of price changes on business enterprises. Statement 33 requires large public enterprises to disclose information on both a historical cost/constant dollar basis and a current cost basis. Current cost information is required for fiscal years ended on or after December 25, 1979, but first presentation of the information can be postponed for one year.

2. If an enterprise does not postpone its first presentation of current cost information, it is required to follow the provisions of Statement 33 for the preparation of that information. Under those provisions, inventory, most kinds of property, plant, and equipment and related expenses are measured at current cost amounts but income-producing real estate and certain other specialized assets may be included at historical cost adjusted by either a specific price index or a general price index.

3. The provisions of Statement 33 for the measurement of income-producing real estate, in information on a current cost basis, are interim provisions applicable for fiscal years ended before December 25, 1980. This Statement extends those interim provisions. It requires enterprises that present information on a current cost basis to combine measures of income-producing real estate and related expenses at either historical cost/constant dollar amounts or at current cost amounts with current cost measures of other assets and expenses. The provisions of this Statement permit use of the same approaches to the measurement of current cost as were permitted under the interim provisions of Statement 33; it also permits the use of other approaches.

4. Statement 33, paragraph 31, provides that an enterprise need not present information on a current cost basis if there would be no material difference between that information and historical cost/constant dollar information. That provision, together with the provisions in this Statement, means that an enterprise needs to present information on a current cost basis only if it has significant holdings of inventory, property, plant, and equipment apart from income-producing real estate and certain other specialized assets.

5. This Statement does not set a time limit on the applicability of its interim provisions. However, the Board will continue to work with its advisory task group for the real estate industry to develop improved methods of measuring income-producing real estate. That work will focus on the relevance, verifiability, and representational faithfulness of various measures, including current cost and fair value, and also on a comparison of the characteristics of various types of assets. In assigning a priority to the work, the Board will take account of the small number of enterprises for which income-producing real estate comprises a major part of their assets. Moreover, several of these enterprises are likely to present information about fair values voluntarily. However, the Board will issue a Statement to supersede the interim provisions of this Statement as soon as that action is justified by the available evidence.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Definition

6. For the purposes of this Statement, the term *income-producing real estate* is defined as follows:

Income-producing real estate comprises properties that meet all of the following criteria:

- a. Cash flows can be directly associated with a long-term leasing agreement with unaffiliated parties.
- b. The property is being operated. (It is not in a construction phase.)
- c. Future cash flows from the property are reasonably estimable.
- d. Ancillary services are not a significant part of the lease agreement.

Supplement to FASB Statement No. 33

7. Paragraph 53 of Statement 33, as amended by Statements 39 and 40, is superseded by the following:

This Statement does not contain provisions for the measurement on a current cost basis of income-producing real estate and unprocessed natural resources and related depreciation, depletion, and amortization expense for fiscal years ended before December 25, 1980 (paragraph 19). If an enterprise presents information on a current cost basis for a fiscal year ended before December 25, 1980, it may measure those assets and related expenses at their historical cost/constant dollar amounts or by reference to an appropriate index of specific price changes.

- a. When an enterprise presents information on a current cost basis for fiscal years ended on or after December 25, 1980, it shall measure: *Mineral resource assets* and related depreciation, depletion, and amortization expense in accordance with the provisions of this Statement for the measurement of property, plant, and equipment and related expenses;
- b. When an enterprise presents information on a current cost basis for fiscal years ended on or after December 25, 1980, it shall measure: *Timberlands and growing timber* and related expenses at either their historical cost/constant dollar amounts or at current cost or lower recoverable amounts;
- c. When an enterprise presents information on a current cost basis for fiscal years ended on or after December 25, 1980, it shall measure: *Income-producing real estate* and related expenses at either their historical cost/constant dollar amounts or at current cost or lower recoverable amounts.

Effective Date and Transition

8. The provisions of this Statement shall be effective for fiscal years ended on or after December 25, 1980.

The provisions of this Statement need not be applied to immaterial items.
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This Statement was adopted by the affirmative votes of four members of the Financial Accounting Standards Board. Messrs. Mosso, Sprouse, and Walters dissented.

Messrs. Mosso, Sprouse, and Walters dissent because this Statement, which is part of a comprehensive standard for measurement of the effects of changing prices, and which concerns a kind of asset that has been dramatically affected by specific price changes, does not deal with that issue in a positive way.

The Board received overwhelming testimony that neither the constant dollar nor the current cost method produces useful information for assessing the impact of specific price changes on real estate investment properties, yet this Statement permits either method to be used in current cost presentations. Of special concern is the relevance of deducting current cost depreciation to measure income from a property that is being maintained to last indefinitely and that is continuing to appreciate in value. Because income-producing real estate is generally held as an investment rather than as an operating capability involving continuous disposals and replacements of components, the effect of changing specific prices on depreciation is not a significant concern. Cash flows and value changes are the critical factors just as they are with other kinds of marketable investments. The relevant accounting analogy is to an investment portfolio not, as implicit in this Statement, to property, plant, and equipment. Estimated fair values and changes in fair values are the most relevant

information that can be provided about the effects of changing prices on income-producing real estate; those estimates are sufficiently reliable to be required as supplementary information. The information obtained during the two years' attention given specifically to the effects of changing prices on income-producing real estate strongly suggests that further delay will not produce new information that might lead to a different conclusion.

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*

Frank E. Block

John W. March

Robert A. Morgan

David Mosso

Robert T. Sprouse

Ralph E. Walters

Appendix A: BACKGROUND

9. Statement 33, issued in September 1979, does not contain provisions for the measurement, on a current cost basis, of certain assets and related expenses for periods ended on or after December 25, 1980. The Board concluded in Statement 33 that further studies were required to provide a basis for decisions on the applicability to those assets of the requirement to present information on a current cost basis.

10. On April 21, 1980, the Board issued an FASB Exposure Draft, *Financial Reporting and Changing Prices: Specialized Assets*. The Board received 124 letters of comment on the Exposure Draft.

11. In July 1980, the Board conducted a public hearing on the Exposure Draft. Twenty-one organizations and individuals presented their views at the two-day hearing.

12. After the issuance of the Exposure Draft, the Board held five open meetings at which it considered the issues dealt with in the Exposure Draft. In addition, the staff has met with the Real Estate Task Group.

13. This Statement differs from the Exposure Draft in that it deals with only income-producing real estate, and it contains no requirement for the separate disclosure of current cost information for income-producing real estate nor any requirement to disclose information about the fair value of income-producing real estate. The Board has issued separate Statements dealing with financial reporting and changing prices for (a) mineral resource assets and (b) timberlands and growing timber.

Appendix B: BASIS FOR CONCLUSIONS

Introduction

14. This appendix reviews considerations that members of the Board deemed significant in reaching the conclusions in this Statement; it includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

15. Statement 33 requires certain large public enterprises to disclose supplementary information on a current cost basis. However, it contains only interim provisions, applicable to years ended before December 25, 1980, for the measurement of income-producing real estate and unprocessed natural resources in information prepared on a current cost basis. This Statement contains further interim provisions for the measurement of income-producing real estate and related expenses for years ended on or after December 25, 1980.

16. During its deliberations on this Statement, the Board considered the following alternatives:

- a. Require measurements on a current cost basis
- b. Require information about fair values, defined as the prices that would be accepted as reasonable in transactions between a willing buyer and a willing seller
- c. Continue provisions similar to those contained in Statement 33; require measurement in information prepared on a current cost basis at either historical cost/constant dollar amounts or at current cost amounts at the option of the preparer
- d. Exempt income-producing real estate from the requirement to present information on a current cost basis.

Current Cost

17. Income-producing real estate has certain special features that raise doubts about the usefulness of the types of current cost measures required for other assets. Those special features affect the relevance of current cost information for the assessment of the maintenance of operating capability, for the assessment of future cash flows, and for the assessment of financial performance.

18. Some Board members and respondents to the Exposure Draft believe that the assessment of the maintenance of operating capability is not important in relation to income-producing real estate. Investors and creditors do not wish to focus on the ability of an enterprise to maintain its physical capability. Such a focus would not contribute significantly to the overall assessment of cash flows. Rather, income-producing real estate should be regarded as investments, much like marketable securities, and assessments should focus directly on the maintenance of the enterprise's ability to generate future cash flows. This approach raises doubts about one of the main uses of current cost information—provision of a basis of assessing operating capability.

19. Some Board members and respondents to the Exposure Draft also believe that conventional methods of measuring depreciation expense (such as the straight-line method) fail to provide useful information about the way in which use of a building is associated with a reduction in expectations of future cash flows. They believe that conventional depreciation methods assume an expiration of service potential that frequently does not, in fact, take place in a well-maintained building. This point of view raises doubts about the usefulness of information about depreciation on a current cost basis for the assessment of enterprise performance.

20. Other Board members believe that a measure of current cost depreciation is needed for income-producing real estate. They believe that income-producing real estate is more similar to other kinds of property, plant, and equipment than to marketable securities and that current cost measures are useful for assessments of enterprise performance. They believe that a conventional measure of depreciation expense can provide information that is useful for the evaluation of managerial performance in operating and leasing real estate, taking account of the expiration of the service potential of the facilities being leased. They also believe that a conventional measure of depreciation expense is needed to distinguish return on capital from return of capital.

21. The Board concluded that some measure of depreciation expense for income-producing real estate is needed in computations of income from continuing operations on a current cost basis. However, it believes that the arguments in favor of requiring current cost information are less strong for income-producing real estate than for other types of property, plant, and equipment. Accordingly, the Board concluded that it should not require enterprises to incur the cost of undertaking current cost measurements of income-producing real estate without further evidence to indicate that the benefits of the information are likely to exceed the costs. Therefore, it decided to permit the use of either historical cost/constant dollar measures or current cost measures of those properties in information on a current cost basis. Accordingly, an enterprise needs to present information on a current cost basis only if it has significant holdings of inventory, property, plant, and equipment apart from income-producing real estate and certain other specialized assets.

Fair Value

22. Information about the fair value of income-producing real estate would be relevant as a basis for assessment of future cash flows if it could be measured with sufficient reliability. Some Board members and respondents to the Exposure Draft favor disclosure of fair value information. They believe that disclosure of estimated fair value information would be more relevant than disclosure of current cost. In addition, some enterprises that own income-producing real estate are likely to disclose information about fair value even if it is not required. These Board members believe it is preferable to provide authoritative guidance about measurement and disclosure rather than allow diverse practices to develop.

23. Other Board members are opposed to the introduction of a requirement for disclosure of fair value information at the present time. They believe that disclosure of fair value involves a focus on an exit price and, accordingly, has implications that go beyond reporting the effects of changing prices. In addition, they are not satisfied that fair value measurements would meet minimum standards of reliability appropriate to inclusion in financial reports. Some of these Board members believe that disclosure of fair value measurements should not be considered until further progress has been made with the conceptual framework at which time it should be

possible to have a better understanding of the broad implications of the uses of such measurements in the real estate industry as well as others. Others believe that low reliability will remain a decisive argument against a requirement to disclose fair values for real estate even after the conceptual framework has been further developed. The Board concluded that no requirements for disclosure of fair value measures should be introduced at the present time.

Definition

24. The Exposure Draft reflected the Board's conclusion that income-producing real estate should include only properties that are leased or are ready for leasing, and real estate for which cash flows are reasonably estimable. Those qualifications were intended to ensure that disclosures of fair value be required only for assets for which the measurements would be reasonably reliable. Comments received on the Exposure Draft indicate that only a small number of companies would have significant amounts of income-producing real estate assets. Hotels, for example, which have occupancy rates and related cash flows that may fluctuate to a relatively large extent, do not meet the criteria for income-producing real estate. While this Statement does not require disclosure of information about fair value, the Board concluded that the definition remains useful. Properties that are not rented for long periods are often used in conjunction with the provision of other services. For the purposes of Statement 33, those properties are included in property, plant, and equipment and are not covered by the special provisions of income-producing real estate. In those cases, the maintenance of operating capability, and, hence, information about current cost, may have greater relevance.

Conclusion

25. The Board concluded that either historical cost/constant dollar amounts or current cost measurements should be permitted as they are in paragraph 53 of Statement 33. In this manner, experimentation may be encouraged without the imposition of the costs of preparing particular computations before sufficient information is available about their usefulness.