



## **Impaired Real Estate Assets Present Accounting Challenges**

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For real estate firms that prepare financial statements in accordance with generally accepted accounting principles (GAAP), the rules regarding asset impairment are particularly challenging. Several years ago, when it seemed that the only conceivable direction real estate values could travel was up, impairment wasn't a big issue. But in the current market, firms need to scrutinize the recorded values of their properties.

Impairment losses have a negative impact on your earnings and your balance sheet. So it's important to understand the circumstances under which you're required to test for impairment and, if testing is required, the methods for determining whether an asset is impaired.

The accounting rules regarding impairment of "long-lived assets," including real estate, vary depending on whether property is to be "held and used" or "disposed of." For purposes of this article, we'll look at real estate that is intended to be held and used.

Note that the impairment rules may apply to individual assets or, in some cases, to groups of assets (those associated with a specific project, for example). For the sake of convenience, however, this article describes the rules in terms of individual properties.

### **A Two-Step Process**

Evaluating real estate for impairment is a two-step process. First, you determine whether there are any impairment indicators – that is, events or changes in circumstances indicating that a property's carrying amount exceeds its property's fair value and may not be recoverable. "Carrying amount" generally means a property's balance-sheet value (historical cost under current rules) net of accumulated depreciation and certain other adjustments.

If these indicators exist, the second step is to measure the undiscounted cash flows expected from the property's use and eventual disposition. If their sum falls short of the property's carrying amount, then you're required to recognize an impairment loss.

Impairment indicators include:

- A significant decrease in market price,
- A significant adverse change in a property's physical condition or in the way it's being used,
- A significant adverse change in legal factors or business climate, including an adverse action or assessment by a regulator,
- Accumulated costs to acquire or construct a property that significantly exceed expectations,
- Expected operating or cash-flow losses, based on current period losses combined with a history of losses or a projection or forecast of continuing losses,
- A current expectation that, more likely than not, a property will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

In the current market, a variety of factors may lead you to conclude that property values may be impaired. Examples include weak rental demand, low occupancy rates, pressure to offer free rent or other concessions to new or renewing tenants, a high percentage of leases about to expire, or financially troubled tenants.

## **Measuring Impairment Losses**

It's important to understand that impairment is not measured by the difference between a property's carrying amount and the undiscounted expected cash flows described above. Rather, if the above analysis requires you to recognize an impairment loss, the loss is equal to the amount by which the property's carrying amount exceeds its fair value.

Under GAAP, fair value is "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." Generally, a property's current market price is the best evidence of fair value. But in the absence of reliable market data, other valuation methods may be appropriate. These might include discounted cash flow analyses or other net present value techniques, as well as market-based methods involving analysis of transactions involving comparable properties.

## **Impact of Impairment Losses**

If you're required to recognize an impairment loss, you must adjust the property's carrying amount downward. The adjusted carrying amount becomes the property's new cost basis, which is depreciated over the property's remaining useful life. You must also record an impairment charge in earnings and make certain financial statement disclosures regarding the nature and measurement of the loss.

In addition to the negative impact on your financial statements, it's important to consider whether impairment losses affect compliance with loan covenants or other obligations tied to balance-sheet ratios or earnings.

## **Fair Value Reporting on the Horizon?**

Real estate firms should also be prepared for a major accounting change on the horizon. The Financial Accounting Standards Board (FASB) may soon require owners of commercial real estate to report property values at fair value rather than historical cost.

For assistance in evaluating impairment losses, or to discuss how fair value accounting, if adopted, will affect your firm, contact your certified public accountant.