



STATE OF ARIZONA

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November 13, 2013

James M. Hacking, Administrator
Public Safety Personnel Retirement System
3010 E. Camelback Rd., Ste. 200
Phoenix, AZ 85016-4416

Dear Mr. Hacking:

In your letter dated July 18, 2013, you asked my Office to answer three questions related to certain investments in real estate assets in which the Public Safety Personnel Retirement System, the Corrections Officer Retirement Plan, and the Elected Officials' Retirement Plan, collectively, the System, have ownership interest. This letter responds to those questions based on the information provided to us and based on interviews with those parties involved in the management, valuation, and audit of those investments.

Specifically, you identified two limited liability companies, each consisting of ownership of retail, residential, and commercial real estate assets managed by Desert Troon Company (DTC). According to the System, in 2010, they changed the method for valuing these real estate assets for financial reporting purposes. The revised valuations were first reported in the System's fiscal year 2012 financial statements. You asked:

- 1) Whether it was reasonable for the System's management to accept the change from an appraisal-based methodology to a discounted cash flow methodology to determine the value of the System's real estate assets managed by DTC;
- 2) Whether it was reasonable for the System's management to report in its fiscal year 2012 financial statements DTC's December 31, 2011, valuation; and
- 3) Whether it would be reasonable for the System's management to report in its fiscal year 2013 financial statements DTC's December 31, 2012, valuation?

To reach our conclusions, we reviewed documents provided to us by the System and DTC. We also interviewed individuals from the System; DTC; Ernst & Young, LLC; ORG Portfolio Management, LLC; and the System's financial statement auditors, Heinfeld & Meech, Co. P.C. These reviews and interviews revealed the following:

- DTC is responsible for managing and valuing the real estate investments held by the two limited liability companies in accordance with management and operating agreements between DTC and the System.
- DTC engaged Ernst & Young to analyze the assumptions, cash flows, and valuations they developed for the System's properties that they managed. Ernst & Young was not engaged to conduct an independent appraisal to determine the value of the System's properties.
- The System engaged ORG to review DTC's valuation methodology for these same real estate assets and determine whether the methodology was reasonable. Based on their review, ORG concluded that the methods used by DTC were reasonable.

We also reviewed relevant sections of accounting standards promulgated by the Governmental Accounting Standards Board and the Financial Accounting Standards Board.

Our response is organized into three sections: 1) a description of the nature of the System's real estate investments and the process for valuing them for financial reporting purposes; 2) an explanation of what generally accepted accounting principles say about financial reporting for real estate investments; and 3) our conclusions and recommendations.

Description of System's real estate investments and valuation process

As part of its responsibility for administering all three retirement plans, the System commingles the monies of the three retirement plans into a single trust and invests, on a long-term basis, accumulated employer and employee contributions and investment earnings. As of June 30, 2012, the audited financial statements of the three retirement plans reported, collectively, \$6,457,700,183 in investments. Of that total amount, \$843,923,193, or 13.1 percent of the collective total investments, was held in real estate investments. Of these real estate investments, \$297,788,191, or 35.3 percent, was managed by DTC through two limited-liability companies.¹ These two limited-liability companies held real estate investments that represent 4.6 percent of the System's total investments of nearly \$6.5 billion. The first limited-liability company, an entity named DTR1, operates as a partnership in which DTC is the managing member. Both the System and DTC have an ownership interest in the real estate investments held by the partnership, with the System owning a 100 percent interest in the commercial property, an 85 percent interest in each retail property, and a 90 percent interest in each lifestyle property with DTC owning the remainder. The second limited-liability company, named DTR1C, includes real estate investments that are wholly owned by the System and managed by DTC in accordance with a management agreement. The properties held by the limited-liability companies comprise properties generating cash flows from leases for their use, properties in development for future generation of income, and vacant land that will be sold for residential development.

Beginning in 2006, for financial reporting purposes, the System adopted a policy to value these real estate investments at market value by obtaining independent appraisals. According to the System, in 2010 they adopted a new method of valuing the real estate assets using an investment-based methodology, based on future cash flows. An investment-based methodology relies on specific assumptions provided by a particular investor and may or may not reflect the actual market value of a property if the property was sold or liquidated on the date of the valuation. This type of valuation is often used for individual operational or investment objectives. In this case, business plans agreed to by DTC and the System, such as future development plans and intended holding periods prior to sale, were used by DTC to project future cash flows from each property. DTC then used these future cash flows as the basis for estimating a current value for each property. Specifically, for each property, DTC applied an interest rate to the sum of the future cash flows and subtracted the accumulated interest from that sum to arrive at the present value of those future cash flows. This methodology is consistent with the terms of the management and operating agreements between the System and DTC. The System reported that it chose this methodology because it intended to hold the properties until the business plan for each property was executed.

¹ Real estate investments managed by DTC are included in the System's financial statements as Desert Troon, Apex Fund I, and Apex Fund II and are listed within the System's real estate portfolio.

Generally accepted accounting principles for investments in real estate

As a governmental entity, the financial statements of the Public Safety Personnel Retirement System, the Corrections Officer Retirement Plan, and the Elected Officials' Retirement Plan are required to be reported in accordance with standards issued by the Governmental Accounting Standards Board (GASB). If requirements and guidance are not provided for in GASB's standards, the requirements and guidance in Financial Accounting Standards Board (FASB) standards may be used if relevant.

GASB's standards require that governmental pension plans report investments at fair value in their financial statements. Fair value is described as the amount at which an investment could be sold in a current transaction between willing parties, other than in a forced or liquidation sale.² Further, GASB standards require that pension plan investments, including real estate, should be reported at their fair value at the reporting date, such as the end of a fiscal year. Fair value is the market price when there is an active market; however, when market prices are not available, fair value should be estimated.³ To date, GASB standards do not provide additional details or guidance that would address how to measure or estimate fair value for real estate investments. However, GASB has issued a preliminary views document on major issues related to fair value measurement and application that describes in more detail how fair value measurements of investments should be made. GASB expects to issue an accounting and reporting standard addressing fair value measurement in December 2014. The concepts and preliminary views reached by GASB to this point are very similar to the requirements currently described in FASB's Codification of Accounting Standards as described below.

FASB also requires investments in real estate to be reported at fair value at the reporting date of the financial statements. FASB further explains that fair value is a market-based measurement, not an entity-specific measurement. For some assets, observable market transactions are available, but even when market information is not available, the objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset would take place between market participants at the measurement date, such as fiscal year-end, under current market conditions.⁴ Assumptions used to estimate fair value should be those assumptions market participants would use. As a result, an entity's intention to hold an asset for a period of time prior to sale is not relevant when measuring fair value.⁵ FASB also requires a priority approach to fair value measures, placing higher priority on observable inputs as opposed to unobservable inputs.⁶ For example, if an asset, such as shares of stock in a company, can be sold in an active market, quoted prices at the measurement date, a clearly observable input, should be used to measure fair value. These types of observable inputs are considered Level 1 inputs. When Level 1 inputs are available, Level 2 or Level 3 inputs should not be used. Some assets are not bought and sold in an active market; however, observable inputs other than quoted market prices, such as prices received on the sale of comparable assets, are available. These types of observable inputs, considered a Level 2 input, should be used in these cases to measure the asset's fair value. Finally, if no Level 1 or Level 2 inputs are available, the entity would use unobservable or Level 3 inputs, such as assumptions developed by the entity owning the asset, to measure fair value. However, FASB indicates that unobservable inputs should be used to measure fair value only to the extent that relevant observable inputs are not available.⁷

² GASB Codification, Section I50.105.

³ GASB Codification, Section Pe5.116.

⁴ FASB Accounting Standards Codification, Section 820.10.05-1B.

⁵ FASB Accounting Standards Codification, Section 820.10.05-1C.

⁶ FASB Accounting Standards Codification, Section 820.10.35-37.

⁷ FASB Accounting Standards Codification, Section 820.10.35-53.

Our conclusions and recommendations

As noted above, DTR1 is a limited-liability company operating as a partnership in which DTC is the managing member. The System and DTC both have an interest in the real estate investments of the partnership. DTR1C is also a limited-liability company; however, it does not operate as a partnership and the System owns 100 percent of the real estate investments held in DTR1C. Our conclusions and recommendations concerning the real estate investments held in DTR1 and DTR1C follow:

DTR1 partnership

DTR1 is a limited-liability company operating as a partnership in which DTC is the managing member. As managing member DTC has full, exclusive, and complete authority to manage and control the business affairs of DTR1. Under the operating agreement between DTC and the System, the System may not withdraw from the partnership and may only transfer its ownership interest in the partnership to another party with the approval of DTC. A change in ownership interests in the partnership can only occur through contributions to the partnership directly from DTC and the System and distributions from the partnership directly to DTC and the System, and cannot be bought or sold in a marketplace. The partnership is scheduled to dissolve effective December 31, 2017, but may be extended through December 31, 2022, with the unanimous consent of DTC and the System. In this case, the System has an ownership interest in a partnership that invests in real estate.

Under generally accepted accounting principles, fair value is an exit price as of a measurement date, such as the end of a fiscal year. In this case, the System cannot redeem its investment in the partnership as of the measurement date. Instead the System's investment in the partnership will be redeemed through distributions as the partnership sells properties and through the final dissolution of the partnership in 2017 or 2022. In such cases generally accepted accounting principles establish that fair value be measured based on the System's ownership interest in the partnership. DTC estimates the value of the System's ownership interest in the partnership annually in accordance with the operating agreement and provides this information to the System. The System reported this value in its 2012 financial statements.

In the future, the System should continue reporting its proportionate interest in the partnership in its financial statements.

DTR1C real estate investments

The investment portfolio of DTR1C consists of retail, lifestyle, and commercial real estate investments that are 100 percent owned by the System. Looking at the portfolio another way, the investments consist of properties in two categories as follows:

- 1) properties with established cash flows, for example, through the lease of retail or commercial properties;
or
- 2) properties with no established cash flows, for example, properties that are under development, properties that will be developed at a future date, and properties being held for future sale with no additional development.

Based on our review of accounting standards, the documents provided to us, and our interviews with those parties involved in managing, valuing, and auditing these investments, we believe valuing properties with established cash flows using a cash flow-based methodology is appropriate for financial reporting purposes; however, we noted some improvements that should be made to the valuation methodology to help ensure it is more consistent with generally accepted accounting principles. Further, we believe that valuing properties with no established cash flows should first consider observable inputs, such as sales prices received for comparable properties, when valuing these types of properties in accordance with generally accepted accounting principles. Specifically:

- **Valuing properties with established cash flows using a cash-flow based methodology is appropriate; however, improvements to the methodology should be made**—An income-based approach using cash flows from executed lease agreements is an appropriate method for valuing income-producing real estate investments for financial reporting purposes. This method was used to value the System's retail, lifestyle, and commercial properties generating income. However, the discount rates (i.e., interest rates) used to determine the valuation should reflect assumptions that market participants would consider when determining a value.

DTC used an income-based approach, specifically the discounted cash flows methodology, to value the System's income-producing retail and lifestyle properties. The assumptions used by DTC to value these properties were reviewed by Ernst & Young and were generally determined to be reasonable and consistent with business plans agreed to by DTC and the System. However, we noted that the discount rate used to value the properties may not be consistent with accounting standards. DTC used a 5 percent discount rate to estimate the value of these properties. Based on documents we reviewed, this discount rate approximated the interest rate on lines of credit required to execute future business plans. However, as noted earlier, the assumptions used to value income-producing properties, such as discount rates, should reflect the assumptions of market participants.

DTC also used an income-based approach, specifically the discounted cash flows methodology, to value the System's income-producing commercial properties. The assumptions used by DTC to value these properties were also reviewed by Ernst & Young and were generally determined to be reasonable and consistent with business plans agreed to by DTC and the System. The discount rates used to estimate the value of these properties ranged from 7.75 percent to 20.5 percent. Based on documents we reviewed, these rates were representative of rates that a new third-party investor might use to value the properties. These rates were more appropriate as they considered assumptions that market participants would consider when valuing a property, as required by FASB.

In the future, the System should ensure that the valuations reported in its financial statements for properties with established cash flows use discount rates that reflect the assumptions of market participants.

- **Valuing properties with no established cash flows should follow FASB standards**—As described on Page 3 of this letter, FASB requires that factors used in valuation follow the fair value hierarchy; specifically, that observable inputs take precedence over unobservable inputs. In addition, FASB states that fair value is a market-based measurement, not an entity-specific measurement, and that fair value determinations should use assumptions a market participant would use when valuing an asset at the measurement date. Finally, FASB establishes that an entity's intention to hold an asset for a period of time prior to sale is not relevant when determining fair value at a measurement date. The methods used by DTC to value properties with no established cash flows did not follow these requirements.

The properties with no established cash flows were valued based on DTC's and the System's future business plans for the properties. Specifically, DTC projected cash flows based on future development plans and intended holding periods prior to sale. By emphasizing these factors, DTC placed precedence on unobservable inputs, which is not consistent with FASB accounting standards. In addition, by considering future business plans for the properties, DTC's valuations relied on assumptions that were not necessarily consistent with the assumptions that market participants would use to value the properties. By valuing properties in this manner, DTC developed an investment value that was specific to the System based on its business plans. Although this type of valuation may be appropriate for operational or investment objectives, it may not accurately reflect the fair value of the property in its current condition at the measurement date. In addition, although these properties will not be sold until some future date, FASB standards are clear that the intent to hold an asset for a period of time is not relevant when determining fair value.

In the future, the System should ensure that the valuations reported in its financial statements for properties with no established cash flows at the measurement date first consider observable inputs, such as prices received on the sale of comparable properties. Unobservable inputs should be used only to the extent that observable inputs are not available. Also, in accordance with FASB standards, the valuation methodology used should consider factors that market participants would consider when valuing a property in a normally functioning market and should not factor in intended holding periods prior to sale.

The System should evaluate the impact of our conclusions and recommendations on the valuations reported in its June 30, 2012, financial statements for real estate investments managed by DTC. If the valuations reported were significantly impacted, the System should consider restating the values reported in the 2012 financial statements.

If you have questions about our conclusions and recommendations, please contact Jay Zsorey, Financial Audit Director, at (602) 553-0333.

Sincerely,

Debbie Davenport
Auditor General