REIT Wise®

NAREIT's Law, Accounting & Finance Conference

NAREIT

March 30 - April 1

2016

Financial Standards Update

April 1, 2016

Agenda - *I Don't Want to Miss a Thing*

- FASB *Leases* Standard
- FASB *Revenue from Contracts with Customers* Standard
- FASB *Clarifying the Definition of a Business* Project
- FASB *Consolidation* Standard

Faculty

- Moderator
  - Christopher Drula, VP Financial Standards, NAREIT
- Panelists
  - Chris Dubrowski, Partner, Deloitte LLP
  - Michelle Montes, Partner, EY
  - Keri Shea, SVP-Finance & Treasurer, AvalonBay Communities, Inc.

The new lease accounting standard

How did we get here, anyway?

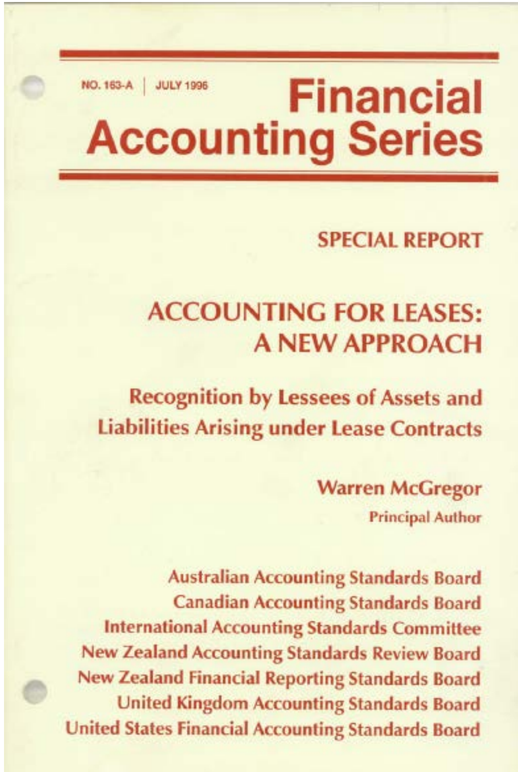
Flawed from the start

Basis for Conclusions, SFAS 13 (1976):

"Some members of the Board who support this Statement hold the view that, regardless of whether substantially all the benefits and risks of ownership are transferred, a lease, in transferring for its term the right to use property, gives rise to the acquisition of an asset and the incurrence of an obligation by the lessee which should be reflected in his financial statements."

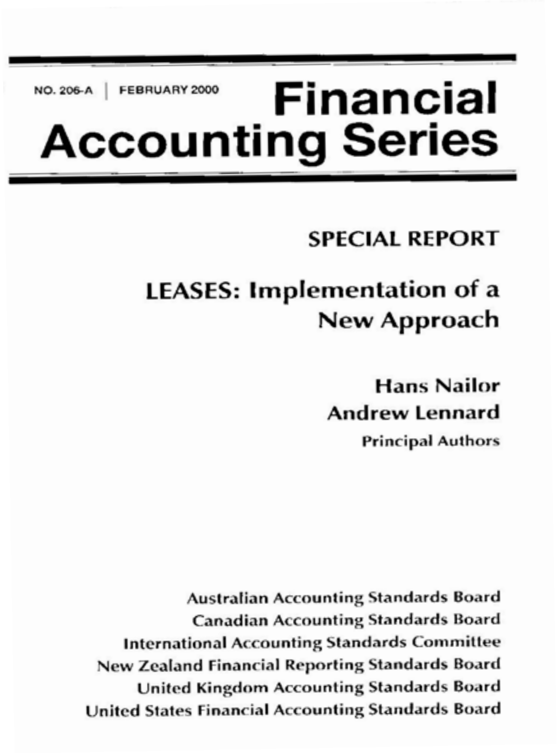
Note-all lessees were male in 1976.

Special Report (1996)



"Thus a lease, by transferring the right to use an item for the lease term…may give rise to the acquisition of an asset and the incurrence of a liability by the lessee, which should be recognized in its financial statements, regardless of whether the lease transfers substantially all the risks and rewards of ownership of that item to the lessee."

Special Report (2000)



NO. 206-A | FEBRUARY 2000

Financial Accounting Series

SPECIAL REPORT

LEASES: Implementation of a New Approach

Hans Nailor
Andrew Lennard
Principal Authors

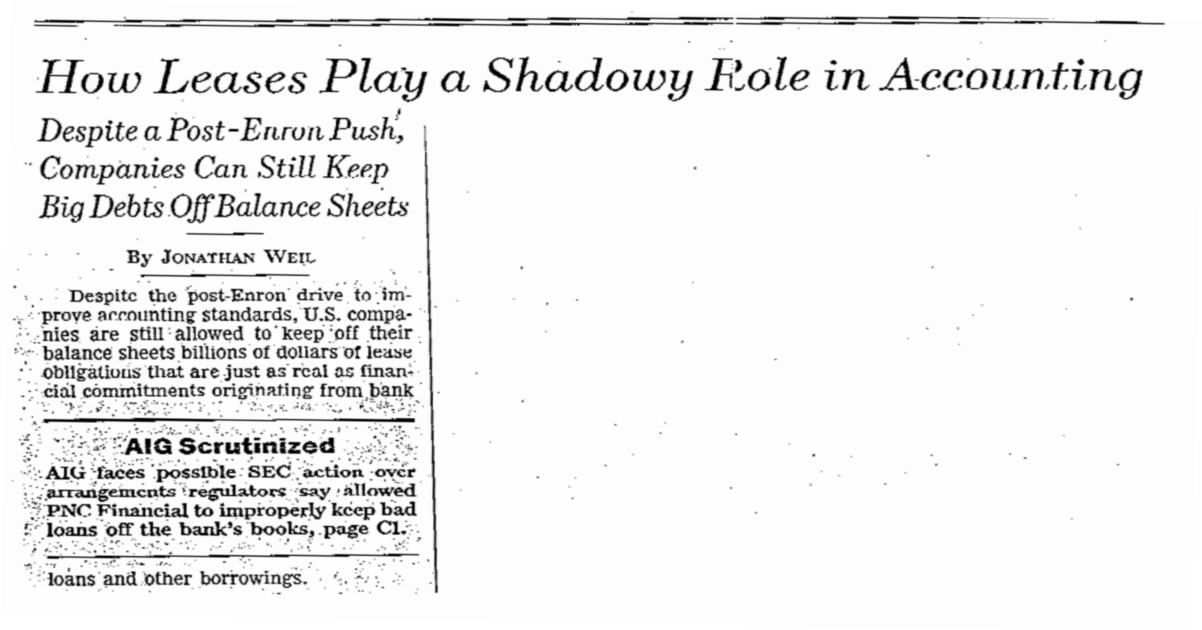
Australian Accounting Standards Board
Canadian Accounting Standards Board
International Accounting Standards Committee
New Zealand Financial Reporting Standards Board
United Kingdom Accounting Standards Board
United States Financial Accounting Standards Board

"The lease has converted some or all of the lessor's existing asset (the item of property) into a financial asset. Thus, some or all of the lessor's existing property asset should be derecognized and reported as a financial asset-a receivable."

Off-balance sheet=bad; structuring=bad

Bright-line tests bring structuring opportunities

Too many liabilities off-balance sheet



How Leases Play a Shadowy Role in Accounting

Despite a Post-Enron Push, Companies Can Still Keep Big Debts Off Balance Sheets

By JONATHAN WEIL

Despite the post-Enron drive to improve accounting standards, U.S. companies are still allowed to keep off their balance sheets billions of dollars of lease obligations that are just as real as financial commitments originating from bank loans and other borrowings.

AIG Scrutinized

AIG faces possible SEC action over arrangements regulators say allowed PNC Financial to improperly keep bad loans off the bank's books, page C1.

OK, let's do this!

Wall Street Journal, September 23, 2004

Group to Alter Rules On Lease Accounting

BRUSSELS—The International Accounting Standards Board next week will unveil plans to overhaul the rules on accounting for leased assets, the board's chairman said yesterday.

loans and other borrowings.

SEC Report – June 15, 2005

“Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers”

~$1.25 trillion in future lease obligations currently not recognized by lessees; recommends “reconsideration” of lease accounting

The Neverending Story

Original Exposure Draft (ED)

Issued in August 2010	Comment period ended December 2010	786 comment letters received

Revised ED

Issued in May 2013	Comment period ended September 13, 2013	656 comment letters received

Final Standard

Issued on February 25, 2016

Effective Date

2019 for publics, 2020 for private entities

Why did this take so long?

"Nobody wants us to rush through this process only to end up with a standard that needs to be amended and deferred. We want to maximize the likelihood that we have a smooth implementation of these new important standards when we feel that we have completed the process to our satisfaction."

Leslie Seidman, FASB Chairman

Lease classification

CLASSIFICATION CRITERIA
Lessor and lessee would account for a lease as a financing lease when: ✓ *Transfers ownership* by the end of the lease term ✓ Includes a purchase option that the lessee is *reasonably certain* to exercise ✓ Term is for the *major part* of the remaining economic life of the underlying asset ✓ Present value of lease payments and the present value of any residual value guarantees amounts to *substantially all* of the fair value of the underlying asset ✓ The asset is of such specialized nature that it would have no alternative use to the lessor at the end of the lease term

The required bright-line rules in current U.S. GAAP are eliminated, but…
842-10-55-2: "When determining lease classification, one reasonable approach to assessing the criteria…would be to conclude both the following:

1) 75% or more of the remaining economic life of the underlying asset is a major part of the remaining economic life of the underlying asset.
2) 90% or more of the fair value of the underlying asset amounts to substantially all of the fair value of the underlying asset."

Lessee accounting models

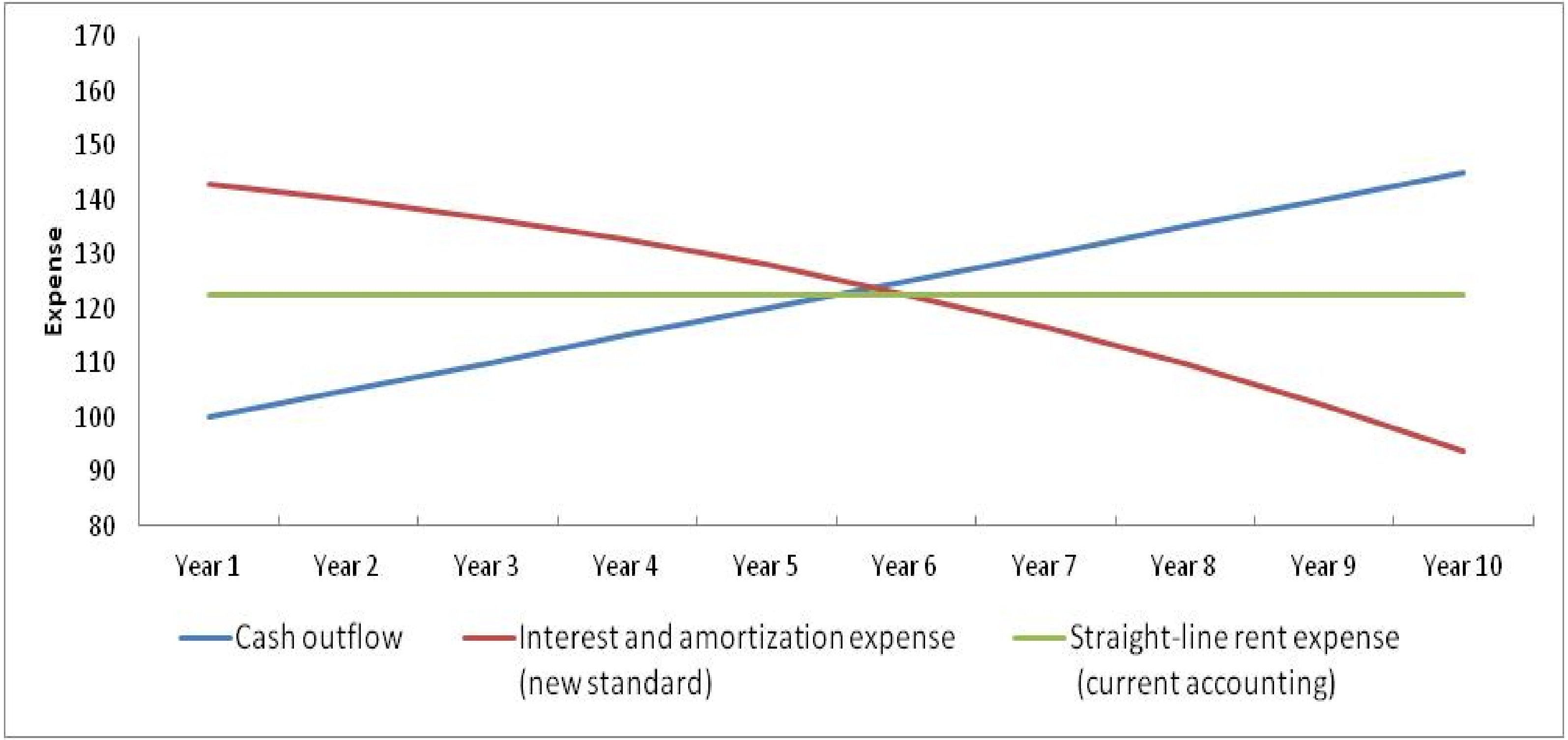
A lessee enters into a three-year lease and agrees to make the following annual payments at the end of each year: $10,000 in year 1, $15,000 in year 2, and $20,000 in year 3. The initial measurement of the right-of-use asset and liability to make lease payments is $38,000 at a discount rate of 8%.

This table highlights the differences in accounting for the lease under the financing approach and straight-line expense approach:

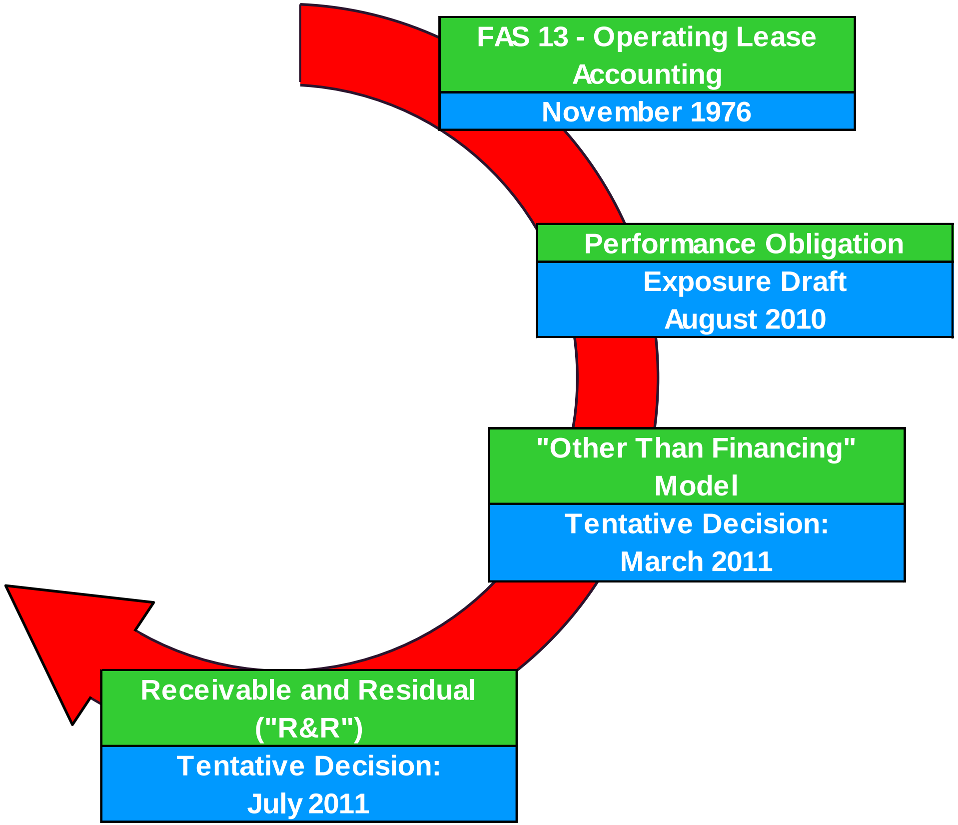
	Both Methods	Financing Approach				Straight-Line Expense Approach		
Year	Lease Liability	Interest Expense <X>	Amortization Expense <Y>	Total Lease Expense <X + Y>	Right-of-Use Asset	Lease Expense <Z>	Reduction in Right-of-Use Asset <Z − X>	Right-of-Use Asset
0	$ 38,000				$ 38,000			$ 38,000
1	31,038	$ 3,038	$ 12,666	$ 15,704	25,334	$ 15,000	$ 11,962	26,038
2	18,520	2,481	12,667	15,148	12,667	15,000	12,519	13,519
3	–	1,481	12,667	14,148	–	15,000	13,519	–
Total		$ 7,000	$ 38,000	$ 45,000		$ 45,000	$ 38,000	

Lessee accounting

Finance lease income statement effect

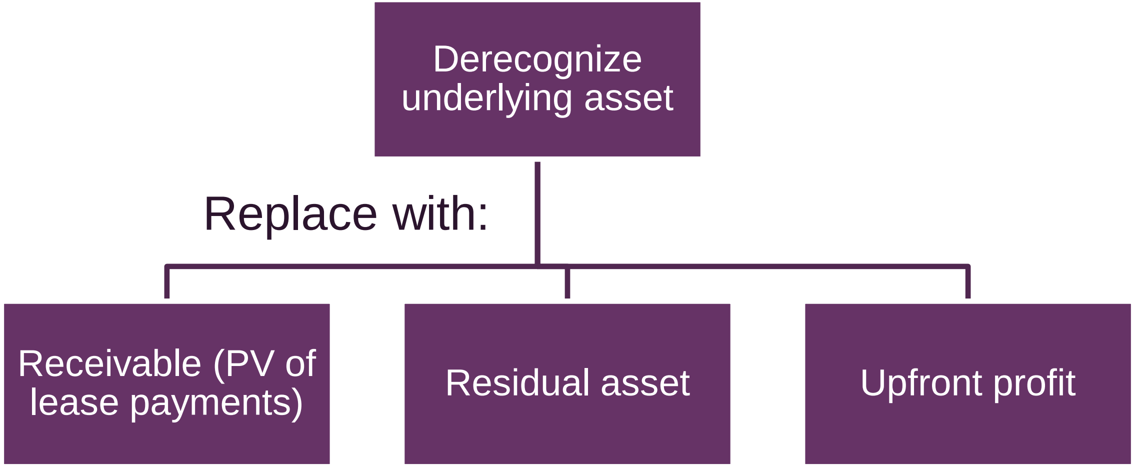


Lessor accounting…



The Receivable and Residual model

- The lessor derecognizes the underlying asset and recognizes
  - A lease receivable measured as the present value of the lease payments, and
  - A residual asset measured on an allocated-cost basis
- Any day-one profit would be recognized



Receivable and residual model-simple calculation?

Calculations necessary for a seven tenant property over a five year period of time

Calculations - Receivable & Residual

Property Cost (at acquisition) 130,000,000
Assumption: All assets are depreciable over a 40 year useful life
Total square footage 320,000
Discount Rate (basis?) 8%

	Market Rent per SQF		
Year	Floors 1 - 2	Floor 3	Floor 4
Year 1	40	44	48.5
Year 2	42.5	46.5	51
Year 3	45	49	53.5
Year 4	47.5	51.5	56
Year 5	50	54	58.5
Year 6	52.5	56.5	61

Contractual Rent

Unit	Square Footage		Year 1	Year 2	Year 3	Year 4	Year 5	Total
1A	80,000		3,200,000	3,400,000	3,600,000	Vacant	Vacant	10,200,000
2A	80,000		3,200,000	3,400,000	3,600,000	3,800,000	4,000,000	18,000,000
3A	40,000		Vacant	Vacant	1,960,000	2,060,000	2,160,000	6,180,000
3B	40,000		Vacant	1,860,000	Vacant	2,060,000	2,160,000	6,080,000
4A	15,000		727,500	765,000	802,500	840,000	877,500	4,012,500
4B	30,000		1,455,000	1,530,000	Vacant	Vacant	Vacant	2,985,000
4C	35,000		1,697,500	1,785,000	1,872,500	1,960,000	Vacant	7,315,000
Total	320,000		10,280,000	12,740,000	11,835,000	10,720,000	9,197,500	54,772,500

Allocation of Cost per Unit

Total Property Cost 130,000,000

Unit	Square Footage	Market Rent per SQF (at acquisition)	Total Market Rent (at acquisition)	Percentage of Total	Allocation of Cost per Unit
1A	80,000	40	3,200,000	23%	30,144,928
2A	80,000	40	3,200,000	23%	30,144,928
3A	40,000	44	1,760,000	13%	16,579,710
3B	40,000	44	1,760,000	13%	16,579,710
4A	15,000	48.5	727,500	5%	6,853,261
4B	30,000	48.5	1,455,000	11%	13,706,522
4C	35,000	48.5	1,697,500	12%	15,990,942
Total	320,000		13,800,000	100%	130,000,000

Depreciation per Unit Per Year (if subject to depreciation)

Unit	Allocation of Cost per Floor		Year 1	Year 2	Year 3	Year 4	Year 5	Total
1A	30,144,928		753,623	753,623	753,623	753,623	753,623	3,768,116
2A	30,144,928		753,623	753,623	753,623	753,623	753,623	3,768,116
3A	16,579,710		414,493	414,493	414,493	414,493	414,493	2,072,464
3B	16,579,710		414,493	414,493	414,493	414,493	414,493	2,072,464
4A	6,853,261		171,332	171,332	171,332	171,332	171,332	856,658
4B	13,706,522		342,663	342,663	342,663	342,663	342,663	1,713,315
4C	15,990,942		399,774	399,774	399,774	399,774	399,774	1,998,868
Total	130,000,000		3,250,000	3,250,000	3,250,000	3,250,000	3,250,000	16,250,000

PP&E by Unit (Gross)

Unit	Square Footage	At acquisition	End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5
1A	80,000	-	-	-	-	27,884,058	27,884,058
2A	80,000	-	-	-	-	-	-
3A	40,000	16,579,710	16,579,710	16,579,710	-	-	-
3B	40,000	16,579,710	16,579,710	-	15,750,725	-	-
4A	15,000	-	-	-	-	-	-
4B	30,000	-	-	-	13,021,196	13,021,196	13,021,196
4C	35,000	-	-	-	-	-	14,391,848
Total	320,000	33,159,420	33,159,420	16,579,710	28,771,920	40,905,254	55,297,101

Depreciation Expense (recognized only when the space is vacant)

Unit	Square Footage		Year 1	Year 2	Year 3	Year 4	Year 5
1A	80,000	-	-	-	-	753,623	753,623
2A	80,000	-	-	-	-	-	-
3A	40,000	-	414,493	414,493	-	-	-
3B	40,000	-	414,493	-	414,493	-	-
4A	15,000	-	-	-	-	-	-
4B	30,000	-	-	-	342,663	342,663	342,663
4C	35,000	-	-	-	-	-	399,774
Total	320,000	-	828,986	414,493	757,156	1,096,286	1,496,060

PP&E by Unit (Net of Accumulated Depreciation)

Unit	Square Footage	At acquisition	End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5
1A	80,000	-	-	-	-	27,130,435	26,376,812
2A	80,000	-	-	-	-	-	-
3A	40,000	16,579,710	16,165,217	15,750,725	-	-	-
3B	40,000	16,579,710	16,165,217	-	15,336,232	-	-
4A	15,000	-	-	-	-	-	-
4B	30,000	-	-	-	12,678,533	12,335,870	11,993,207
4C	35,000	-	-	-	-	-	13,992,074
Total	320,000	33,159,420	32,330,435	15,750,725	28,014,764	39,466,304	52,362,092

Receivable - Beginning of Period

Unit	Square Footage		Beginning Year 1	Beginning Year 2	Beginning Year 3	Beginning Year 4	Beginning Year 5
1A	80,000		8,735,711	6,234,568	3,333,333	-	-
2A	80,000		14,251,157	12,191,250	9,766,550	6,947,874	3,703,704
3A	40,000		-	-	5,295,610	3,759,259	2,000,000
3B	40,000		-	1,722,222	-	3,759,259	2,000,000
4A	15,000		3,181,163	2,708,156	2,159,808	1,530,093	812,500
4B	30,000		2,658,951	1,416,667	-	-	-
4C	35,000		6,029,218	4,814,056	3,414,180	1,814,815	-
Total	320,000		34,856,200	29,086,918	23,969,482	17,811,300	8,516,204

Receivable - End of Period

Unit	Square Footage		End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5
1A	80,000		6,234,568	3,333,333	-	-	-
2A	80,000		12,191,250	9,766,550	6,947,874	3,703,704	-
3A	40,000		-	-	3,759,259	2,000,000	-
3B	40,000		-	-	-	2,000,000	-
4A	15,000		2,708,156	2,159,808	1,530,093	812,500	-
4B	30,000		1,416,667	-	-	-	-
4C	35,000		4,814,056	3,414,180	1,814,815	-	-
Total	320,000		27,364,696	18,673,871	14,052,040	8,516,204	-

Interest Income (Receivable)

Unit	Square Footage		Year 1	Year 2	Year 3	Year 4	Year 5
1A	80,000		698,857	498,765	266,667		
2A	80,000		1,140,093	975,300	781,324	555,830	296,296
3A	40,000				423,649	300,741	160,000
3B	40,000			137,778		300,741	160,000
4A	15,000		254,493	216,652	172,785	122,407	65,000
4B	30,000		212,716	113,333			
4C	35,000		482,337	385,124	273,134	145,185	
Total	320,000	-	2,788,496	2,326,953	1,917,559	1,424,904	681,296

Residual Asset - Beginning of Period

Unit	Square Footage		Beginning Year 1	Beginning Year 2	Beginning Year 3	Beginning Year 4	Beginning Year 5
1A	80,000		21,409,217	23,380,431	25,533,141	-	-
2A	80,000		15,893,770	17,588,387	19,463,685	21,538,931	23,835,443
3A	40,000		-	-	10,455,114	11,661,315	13,006,674
3B	40,000		-	14,442,995	-	11,576,973	12,959,552
4A	15,000		3,672,098	4,050,536	4,467,975	4,928,434	5,436,346
4B	30,000		11,047,571	11,993,856	-	-	-
4C	35,000		9,961,724	10,921,443	11,973,621	13,127,168	-
Total	320,000	-	61,984,380	82,377,647	71,893,537	62,832,820	55,238,015

Residual Asset - End of Period

Unit	Square Footage		End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5
1A	80,000		23,380,431	25,533,141	27,884,058	-	-
2A	80,000		17,588,387	19,463,685	21,538,931	23,835,443	26,376,812
3A	40,000		-	-	11,661,315	13,006,674	14,507,246
3B	40,000		-	15,750,725	-	12,959,552	14,507,246
4A	15,000		4,050,536	4,467,975	4,928,434	5,436,346	5,996,603
4B	30,000		11,993,856	13,021,196	-	-	-
4C	35,000		10,921,443	11,973,621	13,127,168	14,391,848	-
Total	320,000	-	67,934,652	90,210,343	79,139,906	69,629,863	61,387,908

Residual Accretion Rate

Unit	Square Footage		Year 1	Year 2	Year 3	Year 4	Year 5
1A	80,000		9.2%	9.2%	9.2%		
2A	80,000		10.7%	10.7%	10.7%	10.7%	10.7%
3A	40,000				11.5%	11.5%	11.5%
3B	40,000			9.1%		11.9%	11.9%
4A	15,000		10.3%	10.3%	10.3%	10.3%	10.3%
4B	30,000		8.6%	8.6%			
4C	35,000		9.6%	9.6%	9.6%	9.6%	

Residual Accretion

Unit	Square Footage		Year 1	Year 2	Year 3	Year 4	Year 5
1A	80,000		1,971,214	2,152,710	2,350,917		
2A	80,000		1,694,616	1,875,299	2,075,246	2,296,511	2,541,369
3A	40,000				1,206,201	1,345,359	1,500,572
3B	40,000			1,307,729		1,382,580	1,547,694
4A	15,000		378,438	417,439	460,459	507,913	560,257
4B	30,000		946,285	1,027,340			
4C	35,000		959,719	1,052,179	1,153,546	1,264,680	
Total	320,000	-	5,950,272	7,832,695	7,246,369	6,797,043	6,149,892

All for nothing, really

	Contractual Cash Flows	Operating Lease Revenue	Receivable & Residual Revenue
Year 1	$ 10,280,000	$ 11,123,750	$ 8,738,768
Year 2	12,740,000	12,983,750	10,159,649
Year 3	11,835,000	11,691,250	9,163,927
Year 4	10,720,000	10,401,250	8,221,947
Year 5	9,197,500	8,572,500	6,831,189
Total	**$ 54,772,500**	**$ 54,772,500**	**$ 43,115,480**

	Operating Lease Deprec. Expense	Receivable & Residual Deprec. Expense
Year 1	$ 3,250,000	$ 828,986
Year 2	3,250,000	414,493
Year 3	3,250,000	757,156
Year 4	3,250,000	1,096,286
Year 5	3,250,000	1,496,060
Total	**$ 16,250,000**	**$ 4,592,980**

	Operating Lease Net Income	Receivable & Residual Net Income
Year 1	$ 7,873,750	$ 7,909,783
Year 2	9,733,750	9,745,156
Year 3	8,441,250	8,406,771
Year 4	7,151,250	7,125,661
Year 5	5,322,500	5,335,129
Total	**$ 38,522,500**	**$ 38,522,500**

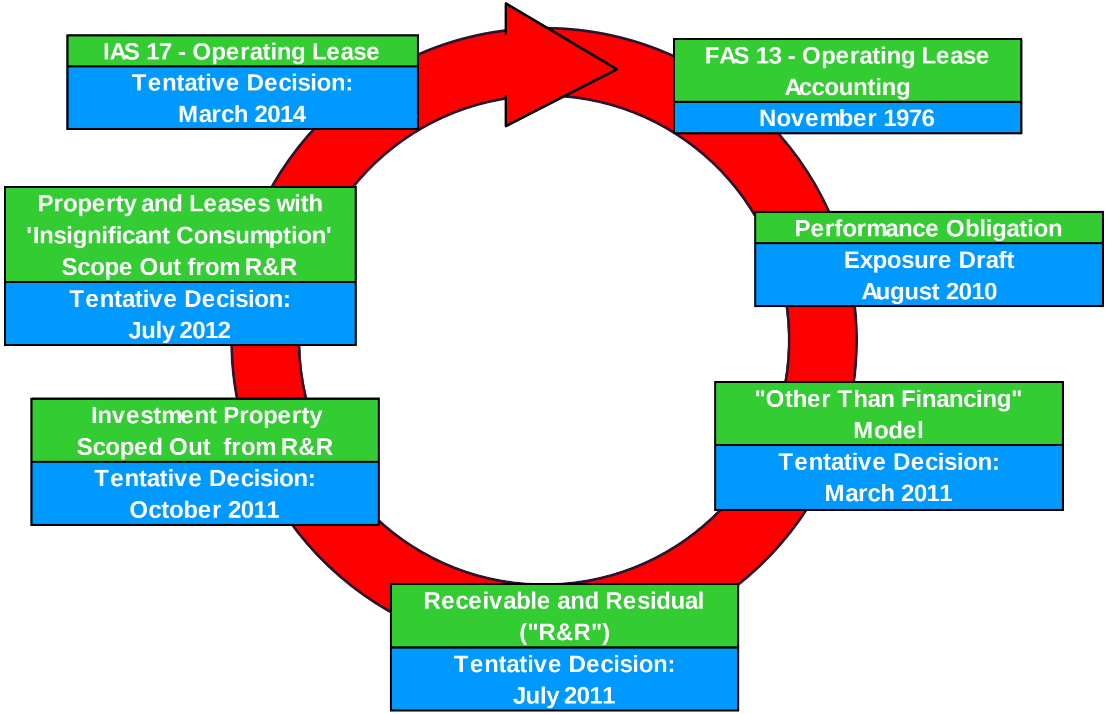
NAREIT spoke, the FASB listened

From the final standard, Basis for Conclusions:

"It would be extremely complicated to apply the approach to leases of portions of a larger asset (that is, when a lessor leases portions of a single asset to multiple parties concurrently, such as one floor of a building)."

Lessor accounting…

"And where I did begin, there I shall end" - Shakespeare



Leases project

Initial direct costs

The Boards decided that only incremental costs would qualify for capitalization.
Costs would be incremental if they would not have been incurred absent the lease being obtained.

Incremental:

- Commissions paid upon execution of a lease (internal or external)
- Payments to existing tenant to incentivize them to terminate their lease

Not incremental:

- Leasing department overhead, unsuccessful efforts
- Advertising, soliciting potential lessees, servicing existing leases
- Costs incurred before lease is obtained, such as legal or tax advice, negotiating the lease, due diligence on potential tenants

This will likely be a change in practice for our industry.

Leases project

Straight-line rent? Not necessarily!

Straight line rent for operating leases

- During redeliberations the FASB and IASB Boards decided that a lessor would recognize rental income on a systematic basis that is not straight line if that basis was more representative of the pattern in which income is earned from the underlying asset
- A lessor would be expected to recognize uneven fixed lease payments on a straight-line basis when the payments are uneven for reasons other than to reflect or compensate for market rentals or market conditions (for example, when there is significant front loading or back loading of payments or when rent-free periods exist in a lease)
- If rent steps are only intended to reflect market rent increases (inflation), can we avoid straight lining?

Leases project

Other interesting items

Sale leaseback transactions

- If the transfer of the asset is determined not to be a sale, the seller-lessee shall not derecognize the transferred asset (accounted for as a financing liability) and the buyer-lessor shall not recognize the transferred asset (accounted for as a receivable)
- Required consistency between seller-lessee and buyer-lessor accounting does not exist in current GAAP-asset can be on both parties' books

Lessee ground lease capitalization

- Existing GAAP allows payments for ground leases to be capitalized during the construction period if the project will be sold or rented
- 842-10-55-21: "…guidance does not address whether a lessee that accounts for the sale or rental of real estate projects under Topic 970 should capitalize rental costs associated with ground and building leases."
- Most ground leases will be "finance leases" on the balance sheet, so will produce interest expense, which will be capitalizable.

Leases project

What about CAM

Standard requires separate accounting for lease and non-lease (services) components of a contract

- Payments by tenant to landlord for taxes and insurance are generally considered part of the lease revenue
- Payments by tenant to landlord for common area maintenance are not part of the lease and should be recognized under the revenue standard

But

BC153: "…it similarly would be reasonable for lessors to account for multiple components of a contract as a single component if the outcome from doing so would be the same as accounting for the components separately (for example, a lessor may be able to conclude that accounting for an operating lease and a related service element as a single component results in the same accounting as treating those two elements as separate components)."

FASB *Revenue from Contracts with Customers* Standard

EY Building a better working world

Revenue recognition

ASU 2014-09

Replaces existing revenue guidance for virtually all industries and arrangements

- ASC 360-20, *Real estate sales,* is superseded

Delayed effective date (ASU 2015-14)

- Public entities – annual periods beginning after 15 December 2017
- Nonpublic entities – additional optional one-year deferral
  - Early adoption allowed for all US GAAP entities as of original public entity effective date (15 December 2016)
  - Early adoption allowed for IFRS entities upon initial issuance of standard

Transition

- Full retrospective – all periods presented using new guidance
- Modified retrospective – new guidance applied only to existing and new contracts in most current period presented; cumulative catch-up recognized at beginning of most current period presented
- SEC Staff provided relief on selected financial data table

Revenue recognition

Summary of the model

Core principle: Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services

Step 1:	Identify the contract(s) with the customer
Step 2:	Identify the performance obligations in the contract
Step 3:	Determine the transaction price
Step 4:	Allocate the transaction price to the performance obligations
Step 5:	Recognize revenue when (or as) each performance obligation is satisfied

Revenue recognition

Real estate sales summary

Transaction: Real estate sales	Considerations
Scope	➢ May be in the scope of ASC 606, ASC 610-20, or ASC 810 ➢ Customer vs. noncustomer; business and/or in substance nonfinancial asset
Seller financing	➢ Initial and continuing investment criteria in ASC 360-20 removed ➢ Evaluation based on buyer’s intent and ability to pay transaction price
Support obligations	➢ Continuing involvement criteria in ASC 360-20 removed ➢ Guarantees ‘carved-out’ and accounted for under ASC 460
Additional services	➢ May represent separate performance obligation and generally would not limit recognition of gain on sale of real estate
Partial sales	➢ Limited guidance in new standard ➢ FASB addressing as part of Definition of a Business project
Developers	➢ May be able to recognize revenue over time if “no alternative use / right to present payment” criteria are satisfied ➢ Criteria difficult to satisfy for most contracts in the US

Revenue recognition

Real estate sales - example

Developer P sells a hotel with a carrying value of $8m to Buyer Q. Developer P receives $1m of cash and provides seller financing of $9m in the form of a five-year amortizing note receivable.

ASC 360-20	ASC 606 / 610-20
➢ Assuming a sale has been consummated, Developer P evaluates Buyer Q's initial investment (10%) and determines that it is not sufficient to qualify for full accrual profit recognition (ASC 360-20 requires 15% investment for hotels) ➢ Developer P therefore recognizes profit using the cost recovery or installment method, depending on whether the cost of the property is reasonably assured ➢ Assuming all other criteria have been satisfied, Developer P may use the full accrual method in the future when payments received from Buyer Q satisfy both the initial and continuing investment tests	➢ Developer P assesses whether it is probable that it will collect the consideration to which it will be entitled (i.e., the transaction price is collectible). *See following slide.* ➢ If Developer P concludes the consideration is collectible, the sale and associated profit of $2m are recognized when control of the property transfers to Buyer Q ➢ When determining whether control has transferred, Developer P considers whether it has a present right to payment for the asset, as well as whether Buyer Q has legal title and physical possession of the property and has the risks and rewards of ownership

Revenue recognition

Real estate sales – example (continued)

- The transaction price (i.e., amount assessed for collectibility) may be different than the stated contract price if an entity concludes it has offered or is willing to accept a price concession
  - Such concessions or discounts are forms of variable consideration that an entity would estimate at contract inception and reduce from the contract price to derive the transaction price

Stated contract price	**$ 10,000,000**
Price concession - amount entity estimates it will offer (explicitly) or accept (implicitly) as a reduction to the contract price, unrelated to credit risk	**$ (2,000,000)**
Transaction price assessed for collectibility	**$ 8,000,000**

  - When an entity is not willing to accept less than the contract price, but is willing to accept the risk of default by the customer of contractually agreed-upon consideration (i.e., credit risk), the transaction price would not differ from the contract price. This amount would be assessed for collectibility

Revenue recognition

Real estate services and “other” summary

Transaction: Real estate services and “other”	Considerations
Property management services	➢ Evaluate whether services represent a “series of distinct services that are substantially the same and have same pattern of transfer to customer” ➢ Variable consideration related to distinct service within series is allocated to the distinct service ➢ Fixed fees or incentive fees may be recognized differently
Leasing services	➢ Unclear whether services are single performance obligation or indeterminate number of separate performance obligations ➢ Pattern of recognition may be the same for either conclusion
Development services	➢ Considerations similar to those described in “property management services” above
Costs incurred to sell real estate projects	➢ Current guidance in ASC 970 removed ➢ New guidance in ASC 340-40 for costs incurred to obtain a contract

Revenue recognition

Real estate services and “other” summary

Transaction: Real estate leases	Considerations
Lease payments	➢ Not within scope of revenue standard – refer to leases project
Common Area Maintenance (CAM)	➢ Additional service to the lessee and would therefore represent a “non-lease component” that is accounted for under the revenue standard ➢ Pro-rata CAM may meet the criteria for recognizing variable consideration related to a “series of services” ➢ Fixed CAM arrangements would likely require over time recognition using a measure of progress
Real estate taxes and insurance	➢ Real estate taxes and insurance are lease components and not within scope of revenue standard
Sale-leaseback transactions	➢ ASC 360-20 will temporarily remain in codification for purposes of evaluating sale-leaseback transactions involving real estate ➢ A seller-lessee and a buyer-lessor use the new revenue guidance and other criteria to determine whether a sale has occurred. If control of an underlying asset passes to the buyer-lessor, the transaction is accounted for as a sale and a lease by both parties. If not, the transaction is accounted for as a financing by both parties

FASB *Clarifying the Definition of a Business* Project

Clarifying the Definition of a Business

Background

- Current definition of a business too broad
- Cost/effort of evaluation
- Interpretation differences with IFRS
- Impacts on
  - Acquisition accounting – record at fair value vs. relative fair value, treatment of acquisition costs
  - Sale accounting

Clarifying the Definition of a Business

Current Definition

- Business = set of acquired activities and assets that must include inputs and one or more substantive processes that together contribute to the ability to create outputs
- Outputs – not required
- Full set of inputs and processes are not required if can be acquired by market participant
- No minimum input and/or process set required

Clarifying the Definition of a Business

ED Proposed Changes/Clarifications

- Eliminate evaluation of market replacement of any missing elements
- Provide "substantially all" threshold for fair value of gross assets acquired
- Narrow the definition of outputs
- Clarify that existence of continuing revenues (i.e., an in-place lease) is not indicative of substantive process being acquired

Clarifying the Definition of a Business

Challenges

- No defined bright line for “substantially all” screen
- Cannot group tangible and intangible assets (i.e., in-place or above/below market lease intangibles)
- Cannot group mixed use acquisitions
- Does not address difference in acquisition costs between asset and business
- Reference Case H and I in ED

Clarifying the Definition of a Business

NAREIT Comment Letter

- Align business combination guidance with existing asset acquisition guidance
- Amend the significance criteria to include a comparison of assets acquired to existing portfolio
- Add guidance that the acquisition of multiple properties in various stages of development would be considered similar assets

FASB *Consolidation* Standard

EY Building a better working world

Recently completed projects

Consolidation (ASU 2015-02)

New guidance makes targeted changes to ASC 810, *Consolidation*

- Effective for public entities in periods beginning after 15 December 2015
- Early adoption permitted; one year deferral for private entities

Focus of project is rescinding FAS 167 deferral for investment companies, but amendments apply to all

Key amendments include:

- Modification of criteria for determining whether fees paid to a decision maker represent a variable interest (focus on whether fees are at market)
- When assessing whether a partnership (or similar entity) is a VIE:
    - No longer consider substance of a general partner’s investment
    - Focus on whether a simple majority of limited partners have kick-out rights or substantive participating rights

Recently completed projects (cont.)

Consolidation (ASU 2015-02)

- Determination of primary beneficiary
  - Benefits criteria exclude fees at market and commensurate with services provided
  - Consider direct and indirect interests held through related parties
- Voting model for partnerships (and similar entities)
  - Eliminates presumption that general partner controls a limited partnership

Consolidation

VIE determination

Scope → Variable Interest → Variable Interest Entity → Primary Beneficiary

Amendments are focused on limited partnerships (LPs) and similar entities (e.g., LLCs)

Changes impact determination of whether equity holders lack the power to direct the activities that most significantly impact the entity's economic performance

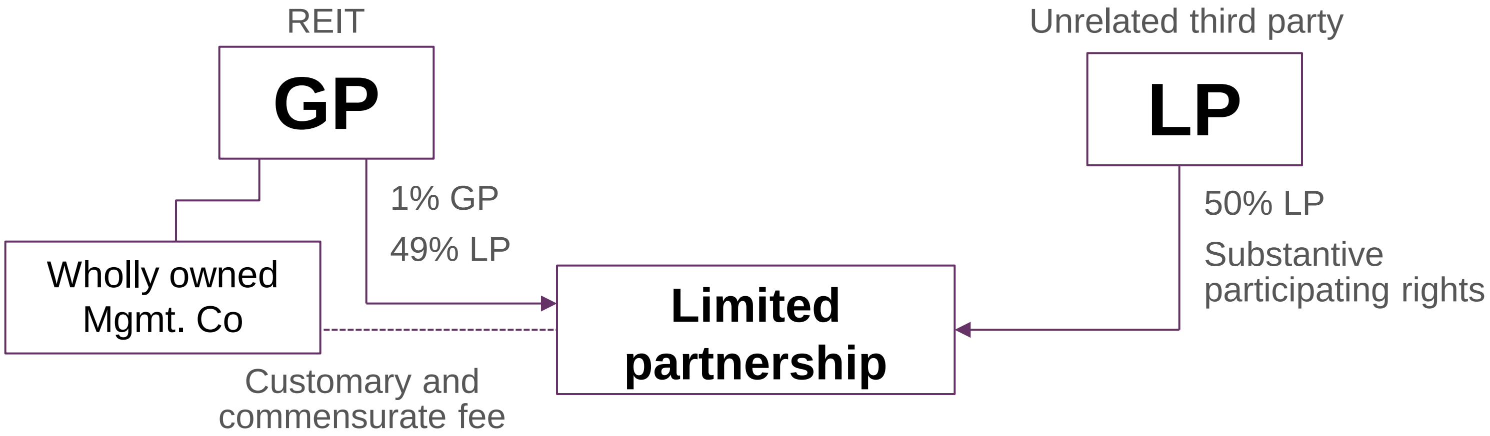
- Evaluation previously focused on whether general partner's at-risk equity investment was substantive

Analysis now based on existence of ***substantive kick-out rights*** or ***substantive participating rights*** held by the limited partners

- Rights are substantive if held by a single limited partner or a simple majority (or lower threshold) of limited partners
- Previously these rights must have been held by a single limited partner

VIE determination

Real estate – example 1

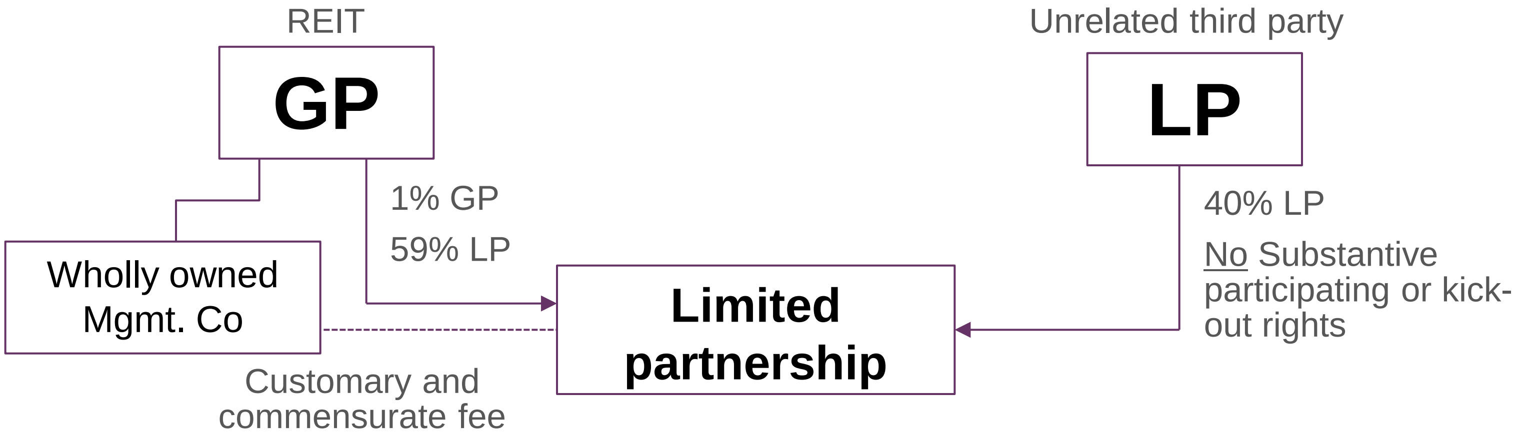


FAS 167: Limited partnership is not a VIE because an at-risk equity holder makes significant decisions. Applying the ASC 810-20 voting model, no party would consolidate

ASU 2015-02: Limited partnership is not a VIE. Applying the amended voting model, no party would consolidate

VIE determination

Real estate – example 2



FAS 167: Limited partnership is not a VIE because an at-risk equity holder makes significant decisions. Applying the ASC 810-20 voting model, REIT would consolidate.

ASU 2015-02: Limited partnership is a VIE because LP’s have no susbtantive kick-out or participating rights. REIT would consolidate as Primary Beneficiary.

Questions?