Concurrent Session: Financial Standards Update

Friday, April 1st
11am – 12:15pm
Marriott Marquis, Washington DC

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Deloitte.

March 2016

Real Estate Spotlight

A Walk-Through of the FASB's New Leases Standard

In This Issue:

The Bottom Line

- On February 25, 2016, the FASB issued its new leases standard, ASU 2016-02.[1] The standard marks the end of the Board's nearly decade-long deliberations with the IASB to address concerns about the current lease accounting requirements.
- The new standard introduces a model that brings most leases onto a lessee's balance sheet. This could significantly change the accounting by real estate lessees, whose leases are typically not included on the balance sheet because they are classified as operating leases under current U.S. GAAP. The new standard retains much of the current lessor model but aligns certain of its underlying principles with those of the new revenue recognition standard (ASC 606[2]).
- The new leases standard will significantly affect lessees and lessors in the real estate industry, including their considerations related to nonlease components, nonlevel rents, initial direct costs, and accounting for sale-leaseback transactions. In addition, real estate lessors will need to understand the ASU's broader implementation implications for lessees as well as the potential for changes in tenant behaviors.
- The new guidance is effective for public business entities for annual periods beginning after December 15, 2018 (i.e., calendar periods beginning after January 1, 2019), and interim periods therein. For all other entities, the ASU is effective for annual periods beginning after December 15, 2019 (i.e., calendar periods beginning on January 1, 2020), and interim periods thereafter. Early adoption is permitted for all entities irrespective of whether such entities elect to early adopt the new revenue standard.

[1] FASB Accounting Standards Update No. 2016-02, *Leases.*

[2] FASB Accounting Standards Codification Topic 606, *Revenue From Contracts With Customers.*

Beyond the Bottom Line

This *Real Estate Spotlight* provides insight into aspects of the new leases standard that are particularly relevant to lessees and lessors in the real estate industry. For a comprehensive overview of the new leases standard, see Deloitte's March 1, 2016, *Heads Up*.

Lessee Accounting

The new standard requires lessees to adopt a right-of-use (ROU) asset approach that brings substantially all leases, with the exception of short-term leases (i.e., those with a lease term of less than 12 months), onto the balance sheet. Under this approach, a lessee records an ROU asset representing its right to use the underlying property during the lease term and a corresponding lease liability (in a manner similar to the current approach for capital leases) regardless of the lease classification. The subsequent accounting for the ROU asset depends on the classification of the lease as either a finance lease or an operating lease (referred to as the "dual-model approach").

A lessee will determine the classification of a lease by using classification criteria that are similar to those under IAS 17.[3] For leases that are considered finance leases, the lessee recognizes interest expense and amortization of the ROU asset in a manner similar to a financed purchase arrangement, which will typically result in greater total expense during the early years of the lease. For leases that are considered operating leases, the lessee will also recognize an ROU asset and lease liability, but will recognize total lease expense on a straight-line basis.

The IASB decided on a different approach for a lessee's subsequent accounting of the ROU asset. Under the IASB's approach, all leases are accounted for as a financed purchase arrangement in a manner consistent with the FASB's guidance on finance leases.

Editor's Note: Under the FASB's dual-model approach, a lease is classified as a finance lease if any of the following criteria are met at the commencement of the lease:

- "The lease transfers ownership of the underlying asset to the lessee by the end of the lease term."
- "The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise."
- "The lease term is for the major part of the remaining economic life of the underlying asset."[4]
- "The present value of the sum of the lease payments and any residual value guaranteed by the lessee . . . equals or exceeds substantially all of the fair value of the underlying asset."
- "The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term."

Although the classification criteria are similar to those under current U.S. GAAP, there are some differences that will apply to the real estate industry. First, the ASU requires entities to account for land and other elements separately unless the effects of not doing so are immaterial. Under current U.S. GAAP, the lease classification of land is evaluated separately from the building if its fair value at lease inception is 25 percent or more of the fair value of the leased property and the lease does not meet either the criterion related to transfer of ownership or the bargain purchase option criterion. This change may result in more bifurcation of real estate leases into separate land and building elements that are required to be evaluated separately for lease classification purposes and accounted for separately.

[3] International Accounting Standard 17, *Leases*.

[4] The ASU provides an exception to this lease classification criterion for leases that commence "at or near the end" of the underlying asset's economic life. The ASU indicates that a lease that commences in the final 25 percent of an asset's economic life is "at or near the end" of the underlying asset's economic life.

Editor's Note (continued): Second, the ASU eliminates the bright-line rules under the ASC 840[5] lease classification requirements — namely, whether the lease term is for 75 percent or more of the economic life of the asset or whether the present value of the lease payments (including any guaranteed residual value) is at least 90 percent of the fair value of the leased asset. While removal of the bright-line test could reduce structuring opportunities, the ASU's implementation guidance indicates that entities may use thresholds similar to those they use today in determining lease classification. Therefore, practice may not be significantly altered as a result of this change.

Lessor Accounting

Although initially the boards contemplated overhauling lessor accounting, they agreed to largely retain the current lessor accounting model. The ASU modifies the current U.S. GAAP lease classification criteria and aligns certain of the underlying principles in the lessor model with the new revenue recognition standard. Specifically, to qualify as a sales-type lease (in which a lessor recognizes profit up front), the arrangement must meet the requirements of a sale under the new revenue recognition guidance. On the other hand, if the transaction does not qualify as a sales-type lease, the transaction would be accounted for (1) as a direct financing lease with any profit deferred and recognized as interest income over the lease term or (2) an operating lease.

Editor's Note: The inability to recognize profit up front on a transaction because the arrangement would not be a sale under the new revenue recognition guidance will probably not significantly affect real estate lessors since such lessors typically do not enter into sales-type leases.

The ASU requires the lessor to account for rental income from operating leases on a straight-line basis unless another systematic basis would be more appropriate. However, to the extent that step rents are used to reflect or compensate the lessor for anticipated market rentals or market conditions, the lessor is required to recognize rental income on a systematic basis other than straight-line.

Editor's Note: Under the ASU, a lessor is only required to recognize rental income on a straight-line basis when payments are uneven for reasons other than to reflect or compensate for market rentals or market conditions (e.g., when there is significant front loading or back loading of payments or when there are rent-free periods in a lease). This may have a significant effect on a lessor's recognition of revenue for operating leases related to real estate since many such leases contain step rents that are intended to reflect expected increases in market rents over the lease term.

Lease and Nonlease Components

Lessees and lessors are required to separate lease components and nonlease components (e.g., any services provided) in an arrangement and allocate the total transaction price to the individual components. Lessors would perform the allocation in accordance with the guidance in the new revenue recognition standard, and lessees would do so on a relative stand-alone-price basis (by using observable stand-alone prices or, if the prices are not observable, estimated stand-alone prices). However, lessees are permitted to elect, as an accounting policy by class of underlying asset, not to separate lease components from nonlease components and instead account for the entire contract as a single lease component.

[5] FASB Accounting Standards Codification Topic 840, *Leases*.

Editor's Note: When evaluating whether an activity should be considered part of a lease component or a separate nonlease component, an entity should consider whether the activity transfers a separate good or service to the lessee. For example, maintenance services (including common-area maintenance services) and utilities paid for by the lessor but consumed by the lessee would be separate nonlease components because the tenant would have been required to otherwise contract for these services separately. However, payments for property taxes or insurance would most likely be considered part of the lease component because they do not transfer a separate good or service to the tenant. This treatment could have the effect of increasing a lessee's lease liability since it would include amounts that are currently considered executory costs. From a practical standpoint, however, such amounts are frequently variable and therefore would not be included in the measurement of the lease liability, as discussed below. See Example 12 in ASC 842-10-55-141 through 55-145[6] for three cases that illustrate the evaluation of whether such costs are considered a lease component.

Variable Lease Payments

In its initial measurement of the lease liability and ROU asset (lessee) or the net investment in the lease (lessor), an entity would only include variable lease payments if such payments are tied to an index or a rate. However, the entity would not include variable lease payments that are based on usage or performance of the asset. A lessee would recognize any variable payments not included in the original lease obligation as an expense in the period the obligation is incurred.[7] A lessor would recognize variable lease payments not included in the original net investment in the lease in the period a change occurs in the facts and circumstances on which the variable lease payments are based (e.g., "when the lessee's sales on which the amount of the variable payment depends occur"). Even if a variable lease payment is virtually certain (e.g., contingent upon a retail store's achievement of a nominal sales volume), the payment would not be included in the calculation of a lessee's lease obligation and ROU asset or a lessor's net investment in the lease.

Example — Variable Lease Payments

On January 1, 20Y1, Company A leased a building for five years, payable in annual lease payments of $100,000 at the beginning of each year. The lease is classified as an operating lease and contains a provision that on December 31 of each year, the lease payments will be adjusted by the change in the CPI for the preceding 12 months. At lease commencement, the CPI is 112. The implicit rate in the lease is not known, and A's incremental borrowing rate is 7 percent. Any initial direct costs and lease incentives are ignored in this example.

Determining the Lease Payments

At lease commencement, A makes its first annual payment of $100,000. In addition, A records a lease liability of $338,721 (the present value of the total remaining lease payments discounted at the incremental borrowing rate) and an ROU asset of $438,721 (the total of the lease liability plus the prepaid rent of $100,000). In measuring these amounts, A did not take into consideration the CPI in effect at lease commencement because the rent increase is based on a change in an index as opposed to the index itself.

On December 31, 20Y1 (the lease payment reset date), the CPI has changed to 126, representing a 12.5 percent increase (i.e., calculated as $[(126 - 112) \div 112]$). Accordingly, A's lease payment in year 2 would be $112,500, comprising the fixed amount of $100,000 and the variable amount of $12,500 (calculated as the change in CPI multiplied by the fixed amount). Further, because A was not required to remeasure its lease liability for any other reason (e.g., a modification), there would be no adjustment to the liability to reflect changes in the CPI. That is, incremental amounts that will be paid in the future because of changes in the CPI would also be recognized as variable lease payments in the period the amounts are paid.

Had the rental increases been based on an index (as opposed to a change in an index), the current — or spot — value of the index would have been used to measure the initial lease liability and ROU asset. Changes in the index over the lease term would result in variable lease payments and would not require revision of the lease liability or ROU asset unless the lease is reassessed for other reasons.

[6] FASB Accounting Standards Codification Topic 842, *Leases*, was added by ASU 2016-02.

[7] The period in which the obligation is "incurred" refers to the period when it becomes probable that the specified target that triggers the variable lease payments will be achieved.

Initial Direct Costs

Under the new standard, a lessee includes initial direct costs in the initial measurement of the ROU asset. A lessor's accounting for initial direct costs is similar to that under current U.S. GAAP. That is, for direct financing leases, a lessor defers all initial direct costs and includes them in the initial measurement of the lease receivable. Similarly, for operating leases, a lessor defers the initial direct costs and amortizes them as expenses over the lease term. For sales-type leases, initial direct costs are expensed up front unless the transaction does not result in a profit or loss.

However, the new standard has changed the definition of initial direct costs to align with the definition of incremental cost in the new revenue recognition guidance. Initial direct costs for both lessees and lessors now include only those costs that are incremental to the arrangement and would not have been incurred if the lease had not been obtained.

Editor's Note: The change in the definition of initial direct costs will affect many real estate entities. Costs such as commissions (whether paid to employees or third-party brokers) and payments made to existing tenants to obtain the lease will continue to be considered initial direct costs. By contrast, costs such as allocated internal costs and costs to negotiate and arrange the lease agreement (e.g., professional fees such as those paid for legal and tax advice) are excluded from this definition. This is likely to result in changes in practice for many real estate lessors, which currently capitalize such costs.

Sale-Leaseback Accounting

The FASB also aligned sale-leaseback accounting with the underlying principles in the new revenue recognition standard. Under the new leases guidance, the seller-lessee in a sale-leaseback transaction must evaluate the transfer of the underlying asset (sale) in accordance with ASC 606 to determine whether the transfer qualifies as a sale (i.e., whether control has been transferred to the buyer). The existence of a leaseback by itself would not indicate that control has not been transferred (i.e., it would not preclude the transaction from qualifying as a sale) unless the leaseback is classified as a finance lease. In addition, if the arrangement includes an option for the seller-lessee to repurchase the asset, the transaction would not qualify as a sale unless (1) the option is priced at the fair value of the asset on the date of exercise and (2) alternative assets exist that are substantially the same as the transferred asset and are readily available in the marketplace.

If the transaction does not qualify as a sale, the seller-lessee and buyer-lessor would account for it as a financing arrangement (i.e., the buyer-lessor would account for its payment as a financial asset and the seller-lessee would record a financial liability).

Editor's Note: Sale-leaseback transactions involving real estate that include a purchase option are not expected to meet the criteria to qualify as a sale, regardless of whether the purchase option is at fair value. Each real estate property is unique and not readily available in the marketplace because of various factors such as location and specified use; therefore, the existence of a purchase option on the real estate, whether it is at fair value or not, is evidence that the real estate is not readily available in the marketplace. Accordingly, in a manner similar to current U.S. GAAP, any purchase options on real estate will preclude sale-leaseback accounting for the seller-lessee.

The new standard will also affect the evaluation of sale-leaseback transactions by the buyer-lessor. Under current U.S. GAAP, the buyer-lessor accounts for its purchase and subsequent lease without regard to the seller-lessee's accounting for the transaction. Under the ASU, the buyer-lessor's and seller-lessee's accounting must be symmetrical. Accordingly, the buyer-lessor must assess whether the seller-lessee has achieved a sale under ASC 606 before it can determine its accounting for the purchase of the real estate assets.

Business Impact and Implementation Considerations

The new lease accounting requirements could change how real estate entities do business and could affect tenant behaviors. For example:

- Since the ASU will result in increased leverage on the balance sheet, tenants may want to negotiate shorter-term leases or leases that include more variable lease payments. Such negotiations could result in increased operating costs for both lessees and lessors.
- An increase in shorter-term leases could also result in higher rental rates and, therefore, additional operating costs. This could also affect (1) the lessor's ability to obtain financing, (2) the financing costs on the property, (3) and the fair value of the lessor's property.
- Because most leases will be on the tenants' balance sheets, tenants may be more motivated to consider whether to lease or purchase a property, particularly those that currently enter into long-term, triple-net leases.
- Bringing leases onto the balance sheet will result in increased leverage and affects an entity's key metrics. Real estate entities that are also lessees under lease agreements (e.g., a land lease for one of the real estate entity's properties) should consider whether the increased leverage could result in debt covenant violations or potentially affect lending decisions.
- The new guidance may complicate a tenant's internal approval of new leases or lease modifications since different individuals may need to closely consider the effects on the financial statements. Under current U.S. GAAP, a tenant's decision to enter into an operating lease may not necessarily receive much opposition or challenge from management. However, operating leases potentially will now be scrutinized as much as out-right purchases because of their effect on the balance sheet. In addition, in its decisions related to leases, an entity may need to involve personnel from a number of departments, such as accounting, corporate reporting, treasury, legal, operations, tax, and information technology.

For a discussion of additional implementation considerations, including those related to the application of judgment and estimation, data management, changes to information technology systems, changes to internal controls and the business process environment, debt covenants, and income taxes, see Appendix F in Deloitte's March 1, 2016, *Heads Up*.

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December 4, 2015
Volume 22, Issue 39

Heads Up

In This Issue

FASB Proposes Amendments to Clarify the Definition of a Business

by Lauren Pesa and Stefanie Tamulis, Deloitte & Touche LLP

On November 23, 2015, the FASB issued a proposed ASU[1] that would clarify the definition of a business in ASC 805[2] and provide a framework that an entity can use to determine whether a set of activities and assets (collectively, a "set") constitutes a business.

The FASB issued the proposed ASU in response to stakeholder feedback indicating that the definition of a business in ASC 805 is too broad and that too many transactions are qualifying as business combinations even though many of these transactions may more closely resemble asset acquisitions. Because the current definition has been interpreted broadly, it can be inefficient and costly to analyze transactions and entities may not be able to use "reasonable judgment." The proposed amendments would make application of the guidance more consistent and cost-efficient.

Editor's Note: Concerns about the definition of a business were among the primary issues raised in connection with the FAF's post-implementation review report on FASB Statement No. 141(R), *Business Combinations* (codified in ASC 805).

Significance of the Proposal

An entity uses the definition of a business in ASC 805 in determining whether to account for a transaction as an asset acquisition or a business combination. This distinction is important because the accounting for an asset acquisition significantly differs from the accounting for a business combination. For example, the acquirer's transaction costs are capitalized in an asset acquisition but are expensed in a business combination. Another difference is that in a business combination, the assets acquired are recognized at fair value and goodwill is recognized; in an asset acquisition, however, the cost of the acquisition is allocated to the assets acquired on a relative fair value basis and no goodwill is recognized.

The FASB considered addressing the concern about the definition of a business more directly by attempting to reduce or eliminate differences between the accounting for business combinations and that for asset acquisitions. However, to respond to stakeholder concerns in a timely fashion, the FASB decided to begin this project by clarifying the definition of a business.

[1] FASB Proposed Accounting Standards Update, *Clarifying the Definition of a Business*.

[2] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Editor's Note: The definition of a business in ASC 805 also affects other aspects of accounting such as disposal transactions, determining reporting units, and the business scope exception in ASC 810. The proposed amendments would cause fewer sets of assets (and liabilities) to be identified as businesses.

Challenges Related to Applying the Current Definition of a Business

The definition of a business would remain unchanged under the proposed ASU. ASC 805 defines a business as:

> An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

The current implementation guidance in ASC 805-10-55-4 states that a "business consists of inputs and processes applied to those inputs that have the ability to create outputs." A business has three elements — inputs, processes, and outputs. All businesses have inputs and processes, and most have outputs, but outputs are not required for a set to be a business. Further, ASC 805-10-55-5 states that "all of the inputs or processes that the seller used" in operating the set do not need to be part of the transaction "if market participants are capable of acquiring the [set] and continuing to produce outputs, for example, by integrating the [acquired set] with their own inputs and processes."

The current implementation guidance does not specify the minimum inputs and processes required for a set to meet the definition of a business, which has led some to interpret the definition of a business broadly. Some have said that a set may qualify as a business even if no processes are acquired when revenue-generating activities continue after an acquisition or if a market participant would be capable of integrating the acquired set with its own processes. For example, some believe that the acquisition of real estate with an in-place lease meets the definition of a business because a market participant is capable of acquiring an input (a building with a lease) and combining it with its own processes (processes to collect rent and maintain the building) to continue generating outputs (rental income). Others have said that the presence of any process can give rise to a business, regardless of the significance of that process.

In addition, ASC 805-10-55-4(c) refers to an output as having "the *ability* to provide a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants" (emphasis added). Many transactions can provide a return in some form (e.g., the acquisition of a new machine might lower costs). Thus, the definition of outputs has further contributed to broad interpretations of the definition of a business.

Main Provisions of the Proposal

The proposed ASU's Basis for Conclusions indicates that the amendments would "narrow the definition of a business and provide a framework that gives entities a basis for making reasonable judgements about whether a transaction involves an asset or a business." In addition, the proposal provides examples illustrating the application of the amendments to the determination of whether a set is a business.

Single or Similar Asset Threshold

The proposed ASU "would provide a practical way to determine when a [set] is not a business." That is, "when substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets," the set would not be considered a business. When this threshold is met, an entity would not need to evaluate the rest of the implementation guidance. The Basis for Conclusions notes that the assessment may be either qualitative or quantitative. In some cases, an entity may be able to qualitatively determine that all of the fair value of the acquisition would be assigned to a single asset or a group of similar assets. An entity may also be able to qualitatively determine that the fair value of the acquisition would be assigned to multiple dissimilar assets, in which case the threshold would not be met. In other cases, an entity may need to perform a quantitative assessment.

In addition, the FASB "decided that the threshold could be met if the fair value is concentrated in a group of similar identifiable assets" (e.g., when "an entity acquires, for example, multiple versions of substantially the same asset type instead of . . . one asset"). The Board further notes that although it intended "to make the analysis practical, the criteria are intended to weigh the need for practicality with the risk that too many items are grouped together to avoid being considered a business."

To avoid inappropriate groupings of assets, the FASB is adding ASC 805-10-55-9C to the proposed ASU. This paragraph indicates that an entity should not combine the following assets into a single asset (or consider them to be similar assets):

a. Tangible and intangible assets (for example, real estate and in-place lease intangibles)
b. Identifiable intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, and in-process research and development), except for groups of identifiable intangible assets that are recognized and measured as a single identifiable asset in accordance with this Topic (for example, complementary intangible assets that have similar useful lives . . .)
c. Financial and nonfinancial assets
d. Different major classes of financial assets (for example, cash, accounts receivable, and marketable securities)
e. Different major classes of tangible nonfinancial assets (for example, inventory, manufacturing equipment, and automobiles).

The following example (reprinted from the proposed ASU) illustrates how to apply the threshold:

Case A: Acquisition of Single-Family Homes

ABC acquires, renovates, leases, sells, and manages single-family residential homes. ABC acquires a portfolio of 10 single-family homes that each have at-market in-place leases. The only elements included in the acquired set are the 10 single-family homes and the 10 in-place leases. Each single-family home includes the land, building, and property improvements. Each home has a different floor plan, square footage, lot, and interior design.

ABC first considers the guidance in paragraph 805-10-55-9A and analyzes whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. ABC must first determine whether each single-family home would be considered a single asset for purposes of this analysis. ABC concludes that the land, building, and property improvements can be considered a single asset in accordance with paragraph 805-10-55-9B. That is, the building and property improvements are attached to the land and cannot be removed without incurring significant cost. However, the in-place lease is an intangible asset and cannot be combined with the tangible real estate in accordance with paragraph 805-10-55-9C.

ABC then considers whether the 10 tangible assets (the combined land, building, and property improvements) are similar. Each home is different; however, the nature of the assets (all single-family homes) are similar. As such, ABC concludes that the group of 10 single-family homes is a group of similar assets.

Next, ABC compares the fair value of the group of similar tangible assets with the fair value of the total gross assets acquired (the combined tangible assets plus the 10 in-place lease assets) and concludes that substantially all of the fair value of the gross assets acquired is concentrated in the group of similar tangible assets. That is, the in-place leases in this Example do not have significant fair value. As such, the set is not a business.

Substantive Process

The proposed amendments would clarify that to be "a business, a transaction must include, at a minimum, an input and a *substantive* process" (emphasis added). Further, the Board points out that "the existence of a process (or processes) is what distinguishes a business from an asset because all asset acquisitions have inputs, and, therefore, providing additional guidance related to processes should help differentiate between [groups of] assets and businesses."

The proposed amendments would not change the definition of process, but they would add two different sets of criteria for entities to consider in determining whether a set has a substantive process; these criteria depend on whether a set has outputs.

A Set With No Outputs

When outputs are not present, an entity would need to apply more stringent criteria when determining whether a set has a substantive process (e.g., an early-stage company that has not generated revenues). The proposal points out that "[b]ecause outputs are a key element of a business and [because] a business usually has outputs, . . . when that key element is missing, the other elements should be more significant." Therefore, to qualify as a business, a set that does not have outputs would need to have both an input and a substantive process. The set would include a substantive process "if it includes an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that, when applied to another acquired input or inputs, is critical to the ability to develop or convert that acquired input or inputs into outputs." The existence of any employee does not mean that a set without outputs should be considered a business. The proposal notes that in the evaluation of whether an acquired workforce is performing a substantive process, the following factors should be considered:

a. A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all the processes required to create outputs.

b. Inputs that the organized workforce could develop (or is developing) or convert into outputs could include the following:

   1. Intellectual property that could be used to develop a good or service
   2. Resources that could be developed to create outputs
   3. Access to necessary materials or rights that enable the creation of future outputs.

   Examples could include technology, mineral interests, real estate, or in-process research and development.

The following example (reprinted from the proposed ASU) illustrates the assessment an entity would perform when a set has no outputs:

Case E: Acquisition of Biotech

Pharma Co. buys all of the outstanding shares of Target Biotech. Target Biotech's operations include research and development activities on several preclinical compounds that it is developing (in-process research and development projects). The set includes the scientists that have the necessary skills, knowledge, or experience to perform research and development activities. In addition, Target Biotech has long-lived tangible assets such as a corporate headquarters, a research lab, and testing equipment. Target Biotech does not yet have a marketable product and, therefore, has not generated revenues.

Pharma Co. first considers the guidance in paragraph 805-10-55-9A and analyzes whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. The identifiable assets in the set include multiple in-process research and development projects and tangible assets (the corporate headquarters, the research lab, and the lab equipment). In addition, Pharma Co. concludes that there is fair value associated with the acquired workforce. Pharma Co. also concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets. Furthermore, because of the significant amount of fair value associated with both the tangible assets and the acquired workforce, Pharma Co. does not assess whether the in-process research and development projects are similar (because even if those projects were similar, the threshold would not be met).

Because the set does not have outputs, Pharma Co. evaluates the criteria in paragraph 805-10-55-5A to determine whether the set has both an input and a substantive process. Big Pharma concludes that the criteria in paragraph 805-10-55-5A are met because the scientists make up an organized workforce that has the necessary skills, knowledge, or experience to perform processes that, when applied to the in-process research and development inputs, is critical to the ability to develop those inputs into a good that can be provided to a customer. The presence of a more than insignificant amount of goodwill is another indicator that the workforce is performing a critical process. Thus, the set includes both inputs and substantive processes and is a business.

A Set With Outputs

The Basis for Conclusions indicates that when a set has outputs (i.e., there is a continuation of revenues before and after the transaction), "it is more likely that the set includes both an input and a substantive process when compared with a set that is not generating outputs." Therefore, the criteria for determining whether a set with outputs has a substantive process are less stringent. ASC 805-10-55-5B (added by the proposed ASU) indicates that the set would include a substantive process if any of the following criteria are met:

a. An organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs, is critical to the ability to continue producing outputs. A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all of the processes required to continue producing outputs.

b. The acquired process (or group of processes), when applied to an acquired input or inputs, contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

c. The acquired process (or group of processes), when applied to an acquired input or inputs, contributes to the ability to continue producing outputs and is considered unique or scarce.

An organized workforce may signify the existence of a substantive process but would not be required if outputs are present. The Basis for Conclusions states, for example, that "an organized workforce might not be required if the set includes automated processes (for example, through acquired technology, infrastructure, or specialized equipment) or other significant processes that contribute to the ability to continue producing outputs."

Further, ASC 805-10-55-5C (added by the proposed ASU) states, in part:

If a set has outputs, a continuation of revenues does not, on its own, indicate that both an input and a substantive process have been acquired. Accordingly, assumed contractual arrangements that provide for the continuation of revenues (for example, customer contracts, customer lists, and leases [when the set is the lessor]) should be excluded from the analysis . . . of whether a [substantive] process has been acquired.

The following example (reprinted from the proposed ASU) illustrates the assessment an entity would perform when a set has outputs:

Case F: License of Distribution Rights

Company A is a global producer of food and beverages. Company A enters into an agreement to license the Latin American distribution rights of Yogurt Brand F to Company B whereby Company B will be the exclusive distributor of Yogurt Brand F in Latin America. As part of the agreement, Company A transfers the existing customer contracts in Latin America to Company B. Companies A and B also enter into an at-market supply contract in which Company B will purchase all of Yogurt Brand F from Company A. Company A retains all of its manufacturing and distribution capabilities. That is, Company B does not acquire manufacturing inputs and processes or distribution inputs and processes (and does not have any of the intellectual property related to those processes or to direct Company A's processes in any way) but only will purchase finished goods from Company A that it will sell and distribute to end customers in Latin America.

Company B first considers the guidance in paragraph 805-10-55-9A and analyzes whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. The identifiable assets that could be recognized in a business combination include the license to distribute Yogurt Brand F, customer contracts, and the supply agreement. Company B concludes that only the license and customer contracts would have fair value assigned to them and that neither asset represents substantially all of the fair value of the gross assets. Company B then considers whether the license and customer contracts are a group of similar intangible assets. Because the license and customer contracts are in different major classes of identifiable intangible assets, they would not be considered similar assets. Therefore, substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets, and Company B must evaluate whether the set has both an input and a substantive process.

The set has outputs through the continuation of revenues with customers in Latin America. As such, Company B must evaluate the criteria in paragraph 805-10-55-5B to determine whether the set includes an input and a substantive process that together contribute to the ability to create outputs. Because the customer contracts are excluded from the determination of whether a process is present in accordance with paragraph 805-10-55-5C, the only elements in the set to evaluate to determine whether a substantive process is present are the license and supply agreement, both of which are inputs. That is, Company B did not obtain any process that could be applied to an acquired input to produce or distribute Yogurt Brand F but, rather, only a right to distribute and the access to purchase Yogurt Brand F. Because the set does not include an organized workforce and there are no acquired processes that could meet the criteria in paragraph 805-10-55-5B(b) through (c), the set is not a business because it does not include both an input and a substantive process.

Definition of Outputs

The proposed amendments would change the definition of outputs to "[t]he result of inputs and processes applied to those inputs that provide goods or services to customers, other revenues, or investment income, such as dividends or interest." The definition of outputs would be narrowed to be consistent with ASC 606, which "describes goods or services that are an output of the entity's ordinary activities." However, not every entity has revenues within the scope of ASC 606. Therefore, the Board decided to incorporate into the definition of outputs other types of revenues. For example, the reference to investment income in the definition of outputs in the proposed amendments was included to ensure that the purchase of an investment company could still qualify as a business combination.

Next Steps

Comments on the proposed ASU are due by January 22, 2016. An entity would apply the proposed amendments prospectively to any transaction that occurs on or after the effective date and would not be required to provide any disclosures at transition. The proposal notes that the FASB "will determine the effective date and whether the proposed amendments may be applied before the effective date after it considers stakeholder feedback on the proposed amendments."

At a later date, the Board will discuss clarifying the guidance on partial sales or transfers of assets that are within the scope of ASC 610-20 as well as the corresponding accounting for the retained interests. The FASB also plans to discuss aligning the accounting for acquisitions of assets with that for businesses.

Convergence With IFRSs

The definition of a business in ASC 805 is currently identical to that in IFRS 3.[3] Nevertheless, the interpretation and application of this term in jurisdictions that apply U.S. GAAP do not appear consistent with those in jurisdictions that apply IFRSs (i.e., the definition of a business in IFRS jurisdictions is not applied as broadly). Although the proposed ASU would add implementation guidance to U.S. GAAP that is not found in IFRSs, the FASB intends to more closely align practice under U.S. GAAP with that under IFRSs by narrowing application of the U.S. GAAP definition. Further, the IASB has added a project on the definition of a business to its agenda and is considering making amendments similar to those in the proposed ASU.

[3] IFRS 3, *Business Combinations*.

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Deloitte.

March 1, 2016
Volume 23, Issue 5

Heads Up

Bring It On!
FASB's New Standard Brings Most Leases Onto the Balance Sheet

by James Barker, Trevor Farber, Stephen McKinney, and Tim Kolber, Deloitte & Touche LLP

After working for almost a decade, the FASB has finally issued its new standard on accounting for leases, ASU 2016-02.[1] The IASB issued its own version, IFRS 16,[2] in January, and although the project was a convergence effort and the boards conducted joint deliberations, there are several notable differences between the two standards. We have highlighted those in the table below.

The primary objective of the leases project was to address the off-balance-sheet financing concerns related to lessees' operating leases. However, developing an approach that requires all operating leases to be recorded on the balance sheet proved to be no small task. During the process, the boards had to grapple with questions such as (1) whether an arrangement is a service or a lease, (2) what amounts should be initially recorded on the lessee's balance sheet for the arrangement, (3) how to reflect the effects of leases in the statement of comprehensive income of a lessee (a point on which the FASB and IASB were unable to converge), and (4) how to apply the resulting accounting in a cost-effective manner.

Accordingly, the FASB's new standard introduces a lessee model that brings most leases on the balance sheet. The standard also aligns certain of the underlying principles of the new lessor model with those in ASC 606, the FASB's new revenue recognition standard (e.g., evaluating how collectibility should be considered and determining when profit can be recognized). Furthermore, the ASU addresses other concerns related to the current almost-40-year-old leases model. For example, it eliminates the required use of bright-line tests in current U.S. GAAP for determining lease classification. It also requires lessors to provide additional transparency into the exposure to the changes in value of their residual assets and how they manage that exposure.

The new standard, which is effective for calendar periods beginning on January 1, 2019, for public business entities and January 1, 2020, for all other entities (see the Effective Date section for more information), represents a wholesale change to lease accounting, and as a result, entities will face significant implementation challenges during the transition period and beyond, such as those related to:

- Applying judgment and making estimates.
- Managing the complexities of data collection, storage, and maintenance.
- Enhancing information technology systems to ensure their ability to perform the calculations necessary for compliance with reporting requirements.

[1] FASB Accounting Standards Update No. 2016-02, *Leases*. The ASU supersedes FASB Accounting Standards Codification (ASC) Topic 840, *Leases*, and creates ASC 842, *Leases*. For titles of additional ASC references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

[2] IFRS 16, *Leases*. For more information on the IASB's standard, see Deloitte's January 13, 2016, *IFRS in Focus*.

- Refining internal controls and other business processes related to leases.
- Determining whether debt covenants are likely to be affected and, if so, working with lenders to avoid violations.
- Addressing any income tax implications.

See Appendix F of the *Heads Up* for more information about an entity's implementation considerations.

This *Heads Up* provides a comprehensive overview of the FASB's new leases accounting model under ASU 2016-02 and highlights a number of implementation considerations. The *Heads Up* also contains the following appendixes, which expand on certain key aspects of the standard:

- Appendix A — Evaluating Whether an Arrangement Is or Contains a Lease.
- Appendix B — Other Significant Provisions. (Topics discussed include lease modifications, separating lease and nonlease components, and accounting for sale-and-leaseback transactions.)
- Appendix C — Presentation Requirements.
- Appendix D — Disclosure Requirements.
- Appendix E — Transition.
- Appendix F — Implementation Considerations.

A Snapshot of the New Guidance

The table below highlights the key provisions of the new leases accounting model under ASU 2016-02 and IFRS 16.

Key Provision	ASU 2016-02	IFRS 16
Scope	Scope includes leases of all property, plant, and equipment (PP&E) and excludes: • Leases of intangible assets. • Leases to explore for or use nonregenerative resources. • Leases of biological assets. • Leases of inventory. • Leases of assets under construction.	Scope includes leases of all assets (not limited to PP&E). Exceptions are similar to those in ASU 2016-02. Also, lessees can elect to apply the guidance to leases of intangible assets.
Short-term lease	A lessee may recognize the payments on a short-term lease on a straight-line basis over the lease term (in a manner similar to its recognition of an operating lease today). These leases would not be reflected on the lessee's balance sheet. A short-term lease is defined as a lease that has a lease term of 12 months or less and does not include a purchase option that the lessee is reasonably certain to exercise.	A lessee may recognize the payments on a short-term lease on a straight-line basis over the lease term (in a manner similar to its recognition of an operating lease today). These leases would not be reflected on the lessee's balance sheet. A short-term lease is defined as a lease that has a lease term of 12 months or less and does not include a purchase option.

<table>
<tr><th>Key Provision</th><th>ASU 2016-02</th><th>IFRS 16</th></tr>
<tr><td rowspan="2">Definition of a lease</td><td>A lease is defined as a "contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipmen t (an identified asset) for a period of time in exchange for consideration."</td><td>A lease is defined as a "contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration."</td></tr>
<tr><td colspan="2">• A leased asset must be specifically identifiable either explicitly (e.g., by a serial number) or implicitly (e.g., the only asset available to satisfy the lease contract).
◦ Substantive substitution rights will need to be considered.
◦ A physically distinct portion of a larger asset could represent a specified asset (e.g., one floor of a building).
◦ A capacity portion of a larger asset will generally not represent a specified asset (e.g., percentage of a storage tank).
• A lease contract conveys the right to control the use of the identified asset for a specified period of time. A customer controls an identified asset when the customer:
◦ Has the right to obtain substantially all of the economic benefits from its use.
◦ Has the right to direct its use.</td></tr>
<tr><td>Leases of low-value assets</td><td>No exemption under U.S. GAAP. However, the FASB believes that an entity will be able to adopt a reasonable capitalization policy under which the entity will not recognize certain lease assets and liabilities that are below a certain threshold.</td><td>A lessee may recognize the payments on a lease of low-value assets on a straight-line basis over the lease term (in a manner similar to its recognition of an operating lease today). These leases would not be reflected on the lessee's balance sheet. IFRS 16 does not define "low value"; however, when the IASB was discussing the exception during deliberations, the Board referred to assets that were less than $5,000.
In addition, an entity will be able to adopt a reasonable capitalization policy under which the entity will not recognize certain lease assets and liabilities that are below a certain threshold.</td></tr>
<tr><td rowspan="2">Lessee accounting</td><td colspan="2">As of the lease commencement date, a lessee recognizes:
• A liability for its lease obligation (initially measured at the present value of the future lease payments not yet paid over the lease term).
• An asset for its right to use the underlying asset (i.e., the right-of-use (ROU) asset) equal to the lease liability, adjusted for lease payments made at or before lease commencement, lease incentives, and any initial direct costs.</td></tr>
<tr><td>The lessee will use the effective interest rate method to subsequently account for the lease liability.
Two approaches are used for subsequently amortizing the ROU asset: (1) the finance lease approach and (2) the operating lease approach.
Under the finance lease approach, the ROU asset is generally amortized on a straight-line basis. This amortization, when combined with the interest on the lease liability, results in a front-loaded expense profile in which interest and amortization are presented separately in the income statement. By contrast, the operating lease approach generally results in a straight-line expense profile that is presented as a single line item in the income statement.
The determination of which approach to apply is based on lease classification criteria that are similar to the current requirements in IAS 17.[3]</td><td>The lessee will use the effective interest rate method to subsequently account for the lease liability.
A single approach (similar to the FASB's finance lease approach) is used to subsequently amortize the ROU asset.</td></tr>
</table>

[3] IAS 17, *Leases*.

<table>
<tr><th>Key Provision</th><th>ASU 2016-02</th><th>IFRS 16</th></tr>
<tr><td>Lessor accounting</td><td>Retains the current lessor accounting approach for operating and capital (direct financing and sales-type) leases.

However, the lease classification criteria will change, and the treatment of dealer’s profit, if any, will be affected:
• A dealer’s profit would be recognized up front if the arrangement is a sales-type lease (i.e., the transaction qualifies as a sale under ASC 606).
• A dealer’s profit resulting from a direct financing lease, if any, would be deferred and recognized as interest income over the lease term.

Eliminates leveraged lease accounting going forward (existing leveraged leases are grandfathered).</td><td>Retains the current lessor accounting approach for operating and finance leases. A dealer’s profit for a finance lease is recognized up front without regard to the revenue guidance in IFRS 15.[4]</td></tr>
<tr><td>Lease term</td><td>Lease term is the noncancelable period in which the lessee has the right to use an underlying asset together with optional periods for which it is reasonably certain that the lessee will exercise the renewal option or not exercise the termination option or in which the exercise of those options is controlled by the lessor. Lessees will be required to reassess the lease term after lease inception if (1) there is a significant event or change in circumstances that is directly attributable to the actions of the lessee, (2) a contract term obliges the lessee to exercise (or not exercise) an option to extend or terminate the lease, or (3) the lessee elects to exercise (or not exercise) an option to renew or terminate the contract that it had previously determined was not reasonably certain to be exercised.

A lessor is not required to reassess the lease term unless the lease is modified and the modified lease is a separate contract.</td><td>Lease term is the noncancelable period in which the lessee has the right to use an underlying asset together with optional periods for which it is reasonably certain that the lessee will exercise the renewal option or not exercise the termination option. Lessees will be required to reassess the lease term after lease inception if (1) there is a significant event or change in circumstances that is directly attributable to the actions of the lessee or (2) the lessee elects to exercise (or not exercise) an option to renew or terminate the contract that it had previously determined was not reasonably certain to be exercised.

A lessor is not required to reassess the lease term unless the lease is modified and the modified lease is a separate contract.</td></tr>
<tr><td rowspan="2">Lease payments</td><td colspan="2">Lease payments include:
• Fixed payments (including in-substance fixed lease payments).
• Variable payments that are based on an index or rate (e.g., LIBOR or the consumer price index (CPI)) calculated by using the index or rate that exists on the lease commencement date (i.e., the spot rate).
• Amounts that it is probable will be owed under residual value guarantees (for lessees), and amounts at which residual assets are guaranteed by a lessee or by a third party (for lessors).
• Payments related to renewal or termination options that the lessee is reasonably certain to exercise.

Lease payments do not include variable lease payments that are based on the usage or performance of the underlying asset (e.g., a percentage of revenues).</td></tr>
<tr><td>Variable payments based on an index or rate would only be reassessed when the lease obligation is reassessed for other reasons (e.g., change in the lease term, modification).</td><td>Variable payments based on an index or rate would be reassessed whenever there is a change in contractual cash flows (e.g., the lease payments are adjusted for a change in the CPI).</td></tr>
<tr><td rowspan="2">Discount rate</td><td colspan="2">• Lessees use the rate charged by the lessor if the rate is readily determinable. If the rate is not readily determinable, lessees will use their incremental borrowing rate as of the date of lease commencement.
• Lessors use the rate they charge the lessee.</td></tr>
<tr><td>Private-company lessees can elect to use a risk-free rate.</td><td>No exemptions provided for private-company lessees.</td></tr>
</table>

[4] IFRS 15, *Revenue From Contracts With Customers*.

<table>
<tr><th>Key Provision</th><th>ASU 2016-02</th><th>IFRS 16</th></tr>
<tr><td>Lease modifications</td><td colspan="2">A lease modification is any change to the contractual terms and conditions of a lease.
• A lessee/lessor would account for a lease modification as a separate contract (i.e., separate from the original lease) when the modification (1) grants the lessee an additional ROU asset and (2) the price of the additional ROU asset is commensurate with its stand-alone price.
• Lessees would account for a lease modification that is not a separate contract by using the discount rate as of the modification effective date to adjust the lease liability and ROU asset for the change in the lease payments. The modification may result in a gain or loss if the modification results in a full or partial termination of an existing lease.
• Lessors would account for a lease modification in a manner generally consistent with the modification guidance in ASC 606 or IFRS 15.
• See Appendix B for more information.</td></tr>
<tr><td>Sublease</td><td>The intermediate lessor would classify a sublease by using the underlying asset of the head lease.</td><td>The intermediate lessor would classify a sublease by using the ROU asset of the head lease.</td></tr>
<tr><td>Sale-and-leaseback arrangements</td><td>The transaction would not be considered a sale if (1) it does not qualify as a sale under ASC 606 or (2) the leaseback is a finance lease.
• A repurchase option would result in a failed sale unless (1) the exercise price of the option is at fair value and (2) there are alternative assets readily available in the marketplace.
• If the transaction qualifies as a sale, the entire gain on the transaction would be recognized.</td><td>The transaction would not be considered a sale if it does not qualify as a sale under IFRS 15.
• A repurchase option would always result in a failed sale.
• For transactions that qualify as a sale, the gain would be limited to the amount related to the residual portion of the asset sold. The amount of the gain related to the underlying asset leased back to the lessee would be offset against the lessee's ROU asset.</td></tr>
</table>

Scope

Like the scope under current requirements, the scope of the new guidance is limited to leases of PP&E. The scope excludes (1) leases of intangible assets; (2) leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources; (3) leases of biological assets; (4) leases of inventory; and (5) leases of assets under construction.

Editor's Note: Under the proposal issued by the boards in May 2013, the scope of the lease accounting guidance would have included inventory (e.g., spare parts and supplies) and construction work in progress (CWIP). However, constituents expressed concerns that if the guidance applied to CWIP, build-to-suit transactions (in which the customer is involved with the construction activity) may be accounted for as leases. In response, the FASB revisited the scope of the guidance in late 2015 and decided to limit it to PP&E. However, it also decided to include guidance on a lessee's control of an underlying asset that is being constructed before lease commencement and related considerations. See Build-to-Suit Arrangements in Appendix B for additional information.

Short-Term Leases

Under the ASU, a lessee can elect (by asset class) not to record on the balance sheet a lease whose term is 12 months or less and does not include a purchase option that the lessee is reasonably certain to exercise (i.e., treat the lease like an operating lease under current U.S. GAAP). When determining whether the lease qualifies for this election, the lessee would include renewal options only if they are considered part of the lease term (i.e., those options the lessee is reasonably certain to exercise — see the Lease Term section below).

A lessee electing this option would recognize lease payments as an expense over the lease term on a straight-line basis. The lessee would also be required to disclose certain information about the short-term lease. If the lease term increases to more than 12 months, or if it is reasonably certain that the lessee will exercise an option to purchase the underlying asset, the lessee would no longer be able to apply the short-term lease exception and would account for the lease as it would other leases.

Example 1 — Short-Term Leases

Scenario 1 — Short-Term Lease Criteria Met

Company A (lessee) enters into an arrangement to lease a crane for a six-month period, with the option to extend the term for up to nine additional months (in three-month increments). After considering the nature of the project, A determines that it expects to use the crane for only nine months and is therefore reasonably certain that it will exercise only one of the three renewal options. Since the lease term is not more than 12 months (in this case 9 months), A would be able to elect the short-term lease exception.

Scenario 2 — Short-Term Lease Criteria Not Met

Company A (lessee) enters into an arrangement to lease a crane for a six-month period, with the option to extend the term for up to nine additional months (in three month increments). The project for which the crane is being used is expected to take 15 months to complete.

After considering the nature of the project, A determines that it expects to use the crane for 15 months and is therefore reasonably certain that it will exercise all three renewal options. Because the expected lease term is greater than 12 months, A would not be able to apply the short-term lease exception; rather, it would be required to record on the balance sheet an ROU asset and corresponding lease liability.

Definition of a Lease

A contract is, or contains, a lease if the contract gives a customer the right to control the use of the identified PP&E (an identified asset) for a period of time in exchange for consideration. Control is considered to exist if the customer has both of the following:

- The "right to obtain substantially all of the economic benefits from use of [an identified] asset."
- The "right to direct the use of that asset."

An entity is required at inception to identify whether a contract is, or contains, a lease. The entity will only reassess whether the contract is or contains a lease in the event of a modification to the terms and conditions of the contract. The inception of a lease is the earlier of the date of an executed lease agreement or the date of commitment by the parties to the principal terms and conditions of the lease.

In many cases, the assessment of whether a contract is or contains a lease will be straightforward. However, the evaluation will be more complicated when an arrangement involves both a service component and a leasing component or when both the customer and the supplier make decisions about the use of the underlying asset. Accordingly, the ASU contains a number of examples of an entity's evaluation of whether a contract is or contains a lease (see ASC 842-10-55-41 through 55-130 in the ASU).

The table below summarizes each key concept related to the definition of a lease. (See Appendix A for more information about the definition of a lease.)

Concept	Requirement[5]	Observation
Use of an identified asset	An asset is typically identified if it is explicitly specified in a contract or implicitly specified at the time the asset is made available for use by the customer. However, if the supplier has substantive rights to substitute the asset throughout the period of use, the asset is not considered "identified."	This requirement is similar to the guidance in ASC 840-10-15 (formerly EITF Issue 01-8[6]). An entity does not need to be able to identify the particular asset (e.g., by serial number) but must instead determine whether an identified asset is needed to fulfil the contract. An entity will need to use significant judgment in distinguishing between a lease and a capacity contract. The standard clarifies that a capacity portion of an asset is an identified asset if it is physically distinct (e.g., a floor of a building). On the other hand, a capacity portion of a larger asset that is not physically distinct (e.g., a percentage of a pipeline) is not an identified asset unless the portion represents substantially all of the asset's capacity.
Substantive substitution rights	A supplier's right to substitute an asset is substantive only if both of the following conditions apply: (1) the supplier has the practical ability to substitute alternative assets throughout the period of use and (2) the supplier would benefit economically from the exercise of its right to substitute the asset.	The FASB established this requirement because it reasoned that if a supplier has a substantive right to substitute the asset throughout the period of use, then the supplier — not the customer — controls the use of the asset. A contract to use a specified type of rail car to transport goods is an example of economic benefit from substitution rights. The supplier benefits from exercise of its right to substitute because it can use its pool of available rolling stock in the most efficient manner.
Right to obtain economic benefits from use of the identified asset	To control the use of an identified asset, a customer must have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use.	The economic benefits from use of an asset include the primary output and by-products of the asset as well as other economic benefits from using the asset that could be realized from a commercial transaction with a third party.
Right to direct the use of the identified asset	A customer has the right to direct the use of an identified asset throughout the period of use if either (1) the customer has the right to direct how and for what purpose the asset is used throughout the period of use or (2) the relevant decisions about how and for what purpose the asset is used are predetermined and (a) the customer has the right to operate (or direct others to operate) the asset throughout the period of use and the supplier does not have the right to change the operating instructions or (b) the customer designed the asset in a way that predetermines how and for what purpose the asset will be used.	The relevant rights to be considered are those that affect the economic benefits derived from the use of the asset. Some examples of customers' rights that meet the definition are (1) rights to change the type of output produced by the asset, (2) rights to change when the output is produced, and (3) rights to change where the output is produced. On the other hand, rights that are limited to maintaining or operating the asset do not grant a right to direct how and for what purpose the asset is used. The standard illustrates the concept of directing use through design of the asset in an example of a contract to purchase all of the output of a solar farm. In the example, the FASB concludes that although the customer makes no decisions during the life of the farm, it has the right to direct its use as a result of having designed the asset before it was constructed.

5 Text is adapted from the ASU.

6 EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease" (codified in FASB Accounting Standards Codification Topic 840, *Leases*).

Lease Classification

An entity is required to determine the classification of a lease as of the lease commencement date.[7] The ASU's classification criteria apply to both lessees (U.S. GAAP only)[8] and lessors (U.S. GAAP and IFRSs). The evaluation focuses on whether control of the underlying asset is effectively transferred to the lessee (e.g., substantially all of the risks and rewards related to ownership of the underlying asset are transferred to the lessee). Therefore, a lease would be classified as a finance lease (from the standpoint of a lessee) or a sales-type lease (from the standpoint of a lessor) if any of the following criteria are met:

- "The lease transfers ownership of the underlying asset to the lessee by the end of the lease term."
- "The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise."
- "The lease term is for the major part of the remaining economic life of the underlying asset."[9]
- "The present value of the sum of the lease payments and any residual value guaranteed by the lessee . . . equals or exceeds substantially all of the fair value of the underlying asset."
- "The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term."

Leases that do not meet any of these criteria (i.e., a lease in which the lessee does not effectively obtain control of the underlying asset) would be classified as operating leases by the lessee and as either operating leases or direct financing leases by the lessor.

Editor's Note: Under the ASU's classification criteria, an arrangement that historically was classified by a lessor as a sales-type lease because the lessor transferred a portion of the risks and rewards of the underlying asset to the lessee and a portion to a third party through a residual value guarantee (e.g., residual value insurance) may no longer qualify as a sales-type lease. In the evaluation of whether a lease qualifies as a sales-type lease, the FASB decided to align the definition of control with its new revenue recognition requirements. Accordingly, the evaluation of whether a lease qualifies as a sales-type lease focuses on whether the *lessee effectively obtains control* of the underlying asset rather than whether the *lessor has relinquished control*.

If a lease does not meet any of the criteria for classification as a sales-type lease, the lessor would still need to assess whether it has relinquished control of the underlying asset to the lessee and other parties involved in the transaction. Accordingly, the lessor would classify a lease that does not meet any of the criteria for a sales-type lease as a direct financing lease if (1) the present value of the lease payments and any residual value guarantee (which could be provided entirely by a third party or could consist of a guarantee provided by the lessee along with a third party guarantee)[10] "equals or exceeds substantially all of the fair value of the underlying asset" and (2) it is probable that the lessor will collect the lease payments and any amounts related to the residual value guarantee(s).

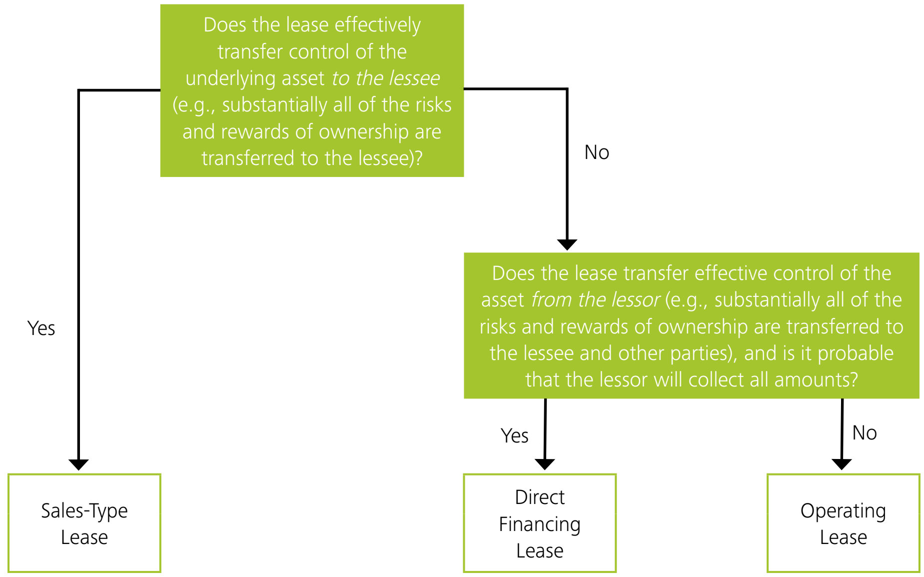
[7] Lease commencement is defined as the date a lessor makes the underlying asset available to a lessee.

[8] A lessee is not required to determine the classification of a lease if the lease is accounted for in accordance with the short-term scope exception. See Appendix B for further details.

[9] The ASU provides an exception to this lease classification criteria for leases that commence "at or near the end" of the underlying asset's economic life. The ASU indicates that a lease that commences in the final 25 percent of an asset's economic life is "at or near the end" of the underlying asset's economic life.

[10] If the present value of lease payments plus a lessee-provided residual value guarantee represents substantially all of the fair value of the underlying asset, the lessor would classify the lease as a sales-type lease.

The following flowchart illustrates the classification of a lease by a lessor:



A lessee is not required to reassess its classification of a lease unless (1) the lease is subsequently modified and the modification is not accounted for as a separate contract or (2) there is a change in the lease term (e.g., there is a change in the assessment of whether the lessee is reasonably certain to exercise a renewal option) or a change in the assessment of the exercise of a purchase option. A lessor would only reassess its lease classification if the lease is subsequently modified and the modification is not accounted for as a separate contract. The accounting underlying each type of lease is discussed in greater detail below in the Lessee Accounting and Lessor Accounting sections.

Editor's Note: While the ASU's classification criteria are similar to those in IAS 17, they are different from the current requirements in U.S. GAAP. As a result, a lease that would have been classified as an operating lease may be classified as a finance lease under the ASU. In addition, as a reasonable approach to assessing significance, an entity is permitted to use the bright-line thresholds that exist under ASC 840 when determining whether a lease would be classified as a finance lease.[11]

In addition, an entity would assess land and other elements in a real estate lease as separate lease components unless the accounting result of doing so would be insignificant. This approach is consistent with the historical approach under IFRSs, but represents a change from current U.S. GAAP guidance, which requires a lessee to account for land and buildings separately only when (1) the lease meets either the transfer-of-ownership or bargain-purchase-price classification criteria or (2) the fair value of the land is 25 percent or more of the total fair value of the leased property at lease inception. This change may result in more bifurcation of real estate leases into separate lease elements.

Lease Term

Under the ASU, the lease term, as determined at lease commencement, is the noncancelable lease period and any optional periods if (1) it is *reasonably certain*[12] that the lessee will exercise a renewal option or not exercise a termination option or (2) the exercise of those options is controlled by the lessor.

[11] Under ASC 840, a lease would be classified as a finance lease if the lease term is 75 percent or more than the remaining economic life of an underlying asset or if the sum of the present value of the lease payments and the present value of any residual value guarantees amounts to 90 percent or more than the fair value of the underlying asset.

[12] The FASB has indicated that "reasonably certain" is substantially the same as the "reasonably assured" threshold under current U.S. GAAP.

When assessing the likelihood of a lessee's exercise of an option, the lessor and lessee would consider the following:

- *Contract-based factors* — The terms of the lease agreement (e.g., a bargain renewal option, a contractual requirement for the lessee to incur substantial costs to restore the asset before returning it to the lessor).
- *Asset-based factors* — Specific characteristics of the underlying asset (e.g., the lessee has installed significant leasehold improvements that would still have economic value when the option becomes exercisable or the facility is in a geographically desirable location with no other viable locations).
- *Entity-specific factors* — The historical practice of the entity, management's intent, and common industry practice.
- *Market-based factors* — Market rentals for comparable assets.

Lessees are required to reassess the lease term when:

- A significant event or change in circumstances occurs that is directly attributable to and clearly within the control of the lessee, and the event or change in circumstances will affect whether the lessee would be reasonably certain to exercise an option to extend the lease, purchase the underlying asset, or terminate the lease.
- A contract term obliges the lessee to exercise (or not exercise) an option to extend or terminate the lease.
- The lessee elects to (1) exercise an option to renew that it had previously determined was not reasonably certain to be exercised or (2) not exercise an option to terminate the contract that it had previously determined was reasonably certain to be exercised.

Lessors would not be required to reassess the lease term unless the lease is modified and the modified lease is a separate contract.

See Appendix B for more information about lease modifications.

Example 2 — Lessee Reassessment of Lease Term

On June 15, 20Y1, Company A leased a building to be used as a storage and distribution warehouse for a 10-year term, with two 5-year renewal options. Company A initially determined that on the lease commencement date it was not reasonably certain that it would exercise either of the renewal options and therefore concluded that the lease term was 10 years.

Scenario 1 — Term Reassessment Would Not Be Required

On January 15, 20Y5, the city in which the warehouse is located significantly improved its highway system, thereby making the warehouse location more desirable for A's distribution needs. This by itself would not result in the need for A to reassess whether it will exercise any remaining renewal options since the significant event or change in circumstances was outside of A's control.

Scenario 2 — Term Reassessment Would Be Required

On January 15, 20Y5, A installed leasehold improvements with a 10-year estimated useful life. The cost of the improvements was significant, and A is now reasonably certain to exercise at least one of its renewal options to avoid losing the value associated with the improvements. In this case, since the change in circumstances is directly attributable to A's actions, reassessment would be required.

Lease Payments

In the calculation of a lessee's lease obligation and ROU asset or a lessor's net investment in the lease, the lease payments are measured as the total of (1) fixed payments, including in-substance fixed payments; (2) variable payments based on an index or a rate; (3) amounts that it is probable a lessee will owe under a residual value guarantee (lessee) or the amount of the residual value guarantee (lessor); and (4) payments related to purchase or termination options that the lessee is reasonably certain to exercise. In addition, in measuring the ROU asset, the lessee would adjust its lease payments for any lease incentives that are paid or payable.

Fixed Payments, Including In-Substance Fixed Payments

Fixed payments are payments that are specified in the lease agreement and fixed over the lease term. Fixed payments also include variable lease payments that are considered in-substance fixed payments (e.g., a variable payment that includes a floor or a minimum amount).

Editor's Note: Even if a variable lease payment is virtually certain (e.g., a variable payment for highly predictable output from a solar farm or a variable payment if a retail store meets a nominal sales volume), such a payment would not be considered an in-substance fixed payment. Therefore, it would not be included in the determination of a lessee's lease obligation and ROU asset or a lessor's net investment in the lease.

Variable Lease Payments

An entity would include variable lease payments that depend on an index or a rate in the initial measurement of the lease liability and ROU asset (lessee) or the net investment in the lease (lessor) by using the spot index or rate at lease commencement. By contrast, the entity would *not* include variable lease payments based on usage or performance of the asset. A lessee would recognize any variable payments not included in the original lease obligation as an expense in the period the obligation is incurred.[13] A lessor would recognize variable lease payments not included in the original net investment in the lease in the period a change occurs in the facts and circumstances on which the variable lease payments are based (e.g., "when the lessee's sales on which the amount of the variable payment depends occur").

A lessee is required to reassess variable lease payments when the lease liability is remeasured as a result of the following:

- The lease is modified and the modification is not treated as a separate contract.
- A contingency upon which a variable lease payment that is excluded from the measurement of lease payments becomes resolved such that the variable payment will now be included in the measurement of the lease payments (e.g., a variable lease payment that is based on a sales target subsequently converts to a fixed lease payment).
- There is a change in:
    - The lease term.
    - The assessment of whether the lessee will exercise a purchase option.
    - The amount that it is probable the lessee will owe under a residual value guarantee.

Any changes related to future periods would result in an adjustment to the lease obligation and ROU asset. A lessor is not required to reassess variable lease payments unless the lease is modified and the modification is not accounted for as a separate contract.

[13] The period in which the obligation is "incurred" refers to the period when it becomes *probable* that the specified target that triggers the variable lease payments will be achieved.

Editor's Note: While the FASB aligned many of the lessor accounting requirements with the new revenue guidance in ASC 606, the treatment of variable consideration under the two models differs significantly. Under ASC 606, variable revenues are estimated and included in the transaction price subject to a constraint, whereas under the leases standard, variable lease payments would generally be excluded from the determination of a lessor's lease receivable. Accordingly, there is a possibility that direct financing leases or sales-type leases that have a significant variable component may result in inception losses for the lessor if the lease receivable plus the unguaranteed residual asset is less than the net carrying value of the underlying asset being leased. This could occur if payments on a lease of, for example, a solar farm are based entirely on the production of electricity (i.e., 100 percent variable). Since many feel that this outcome does not faithfully represent the economics of these transactions, we are considering other possible approaches to applying the new standard to such contracts, including the use of a negative discount rate, which would avoid the inception loss. Lessors that are affected by this issue should consult with their professional advisers and monitor developments during the implementation phase of the ASU.

Example 3 — Variable Lease Payments

On January 1, 20Y1, Company A leased a building for five years, payable in annual lease payments of $100,000 at the beginning of each year. The lease is classified as an operating lease and contains a provision that on December 31 of each year, the lease payments will be adjusted by the change in the CPI for the preceding 12 months. At lease commencement, the CPI is 112. The implicit rate in the lease is not known, and A's incremental borrowing rate is 7 percent. Any initial direct costs and lease incentives are ignored in this example.

Determining the Lease Payments

At lease commencement, A makes its first annual payment of $100,000. In addition, A records a lease liability of $338,721 (the present value of the total remaining lease payments discounted at the incremental borrowing rate) and an ROU asset of $438,721 (the total of the lease liability plus the prepaid rent of $100,000). In measuring these amounts, A did not take into consideration the CPI in effect at lease commencement because the rent increase is based on a change in an index as opposed to the index itself.

On December 31, 20Y1 (the lease payment reset date), the CPI has changed to 126, representing a 12.5 percent increase (i.e., calculated as [(126 − 112) ÷ 112]). Accordingly, A's lease payment in year 2 would be $112,500, comprising the fixed amount of $100,000 and the variable amount of $12,500 (calculated as the change in CPI multiplied by the fixed amount). Further, because A was not required to remeasure its lease liability for any other reason (e.g., a modification), there would be no adjustment to the liability to reflect changes in the CPI. That is, incremental amounts that will be paid in the future because of changes in the CPI would also be recognized as variable lease payments in the period the amounts are paid.

Had the rental increases been based on an index (as opposed to a change in an index), the current — or spot — value of the index would have been used to measure the initial lease liability and ROU asset. Changes in the index over the lease term would result in variable lease payments and would not require revision of the lease liability or ROU asset unless the lease is reassessed for other reasons.

Residual Value Guarantees

The ASU defines a residual value guarantee as a "guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of a lease will be at least a specified amount." Under current U.S. GAAP, a lessee includes in its minimum lease payments the entire amount of the residual value guarantee, whereas under the ASU, a lessee only includes those amounts that it is probable will be owed under the residual value guarantee at the end of the lease term. A lessee is required to remeasure lease payments when there is a change in the amount that it is probable will be owed by the lessee under a residual value guarantee. Revised lease payments would reflect changes in the amounts that it is probable will be owed by the lessee under residual value guarantees and would be recognized as an adjustment to the lease liability and the ROU asset.

A lessor would include in its lease receivable the full amount at which the residual asset is guaranteed by the lessee or a third party. Unlike a lessee, the lessor would not reflect any changes in the residual value in its lease receivable. However, changes in the unguaranteed residual value would be considered in the overall assessment of whether the net investment in the lease is impaired.

Example 4 — Residual Value Guarantee

A lessor leases equipment to a lessee for five years at $10,000 per year. The lessee guarantees that the equipment will have a residual value of at least $9,000 at the end of the lease. The expected residual value at the end of the lease term is $20,000.

Lessee Accounting

In its lease payment calculation, the lessee would only include the amount that it is probable it will owe under the residual value guarantee at the end of the lease term. Accordingly, the lessee would not include any amount in the initial measurement of the lease liability and ROU asset, because the expected residual value is greater than the guaranteed amount. However, if the expected residual value of the asset subsequently decreased (e.g., to $4,000) and, accordingly, the lessee now believes that it is probable that it will make a payment under the residual value guarantee, the lessee would need to adjust the lease liability and the ROU asset to reflect the present value of the $5,000 expected to be owed.

Lessor Accounting

In the calculation of its lease receivable, the lessor would include the portion of the residual asset that is guaranteed by the lessee (or any other party). Accordingly, in addition to the present value of the five annual lease payments of $10,000, the lessor would include the present value of the $9,000 guaranteed amount in its calculation of the lease receivable. The lessor's net investment in the lease would consist of the total receivable (including the residual value guarantee) and the present value of the unguaranteed residual asset of $11,000. The lessor would not make any subsequent adjustments to its net investment in the lease for changes in the guaranteed residual value. However, changes in the unguaranteed residual value would be considered in the overall assessment of whether the net investment in the lease is impaired.

Editor's Note: As discussed above, under the new standard a lessee would include in its lease payments only those amounts related to a residual value guarantee that it is probable the lessee will owe at the end of the lease term. Lease arrangements (such as a synthetic lease arrangement) in which a significant portion of the lease payments are structured as a residual value guarantee could therefore result in ROU assets and lease liabilities that are significantly lower than those in arrangements in which more of the lessee's obligation takes the form of rents. For example, since many real estate assets are expected to hold their value over the lease term, amounts that it is probable the lessee will owe under residual value guarantees may be nominal. Accordingly, while these arrangements will be brought onto the balance sheet, synthetic leases and other lease arrangements in which a significant portion of lease payments are structured as a residual value guarantee may continue to yield favorable accounting results (e.g., reduced leverage) under the new leasing guidance.

Discount Rate

Under the ASU, the discount rate used by a lessee and a lessor is based on the information available as of the lease commencement date. A lessee should use the rate that the lessor charges in the lease (i.e., the rate implicit in the lease) if that rate is readily determinable. If the rate is not readily determinable, which is generally expected, the lessee should use its incremental borrowing rate as of the date of lease commencement. Lessors should use the rate they charge the lessee (i.e., the rate implicit in the lease) and are not required to reassess the discount rate used when there is a change in lease term. The discount rate must be updated by the lessee if there is a remeasurement of the lease liability unless the remeasurement results from changes in one of the following:

- The lease term or the assessment of whether a purchase option will be exercised, and the discount rate already reflects the lessee's option to extend or terminate the lease or purchase the asset.

- Amounts that it is probable the lessee will owe under a residual value guarantee.
- Lease payments resulting from the resolution of a contingency upon which some or all of the variable lease payments are based.

When there is a modification that does not result in a separate contract, a lessee and lessor would, in certain instances, be required to reassess the discount rate used when accounting for the modified lease. See the Lease Modifications section in Appendix B.

When measuring their lease liabilities, nonpublic business entities are permitted to make an accounting policy election to use the risk-free discount rate for all leases in lieu of their incremental borrowing rate. Using the risk-free rate would result in a larger lease liability and ROU asset.

Lessee Accounting

Initial Measurement

The initial measurement of a lease is based on an ROU asset approach. Accordingly, **all** leases (finance and operating leases) other than those that qualify for the short-term scope exception must be recognized as of the lease commencement date on the lessee's balance sheet. A lessee will recognize a liability for its lease obligation, measured at the present value of lease payments not yet paid (excluding variable payments) and a corresponding asset representing its right to use the underlying asset over the lease term. The initial measurement of the ROU asset would also include (1) initial direct costs (e.g., legal fees, consultant fees, commissions paid) that are directly attributable to negotiating and arranging the lease that would not have been incurred had the lease not been executed and (2) any lease payments made to the lessor before or at the commencement of the lease. The ROU asset would be reduced for any lease incentives received by the lessee (i.e., consideration received from the lessor would reduce the ROU asset).

Subsequent Measurement

Although the FASB and IASB agreed on the lessee's initial measurement of a lease, they differed on the lessee's subsequent measurement of the ROU asset as follows:

- *Dual-model approach (FASB)* — Lessees classify a lease as either a finance lease or an operating lease (see the Lease Classification discussion above).
- *Single-model approach (IASB)* — Lease classification is eliminated, and all leases are accounted for in a manner consistent with the accounting for finance leases under the FASB's approach.

Editor's Note: The FASB adopted a dual-model approach because it believes that all leases are not created equal; that is, some leases are akin to a financing arrangement for the purchase of an asset, while others are simply rental of the underlying property. By contrast, the IASB believes that the single-model approach (i.e., one that eliminates lease classification) has greater conceptual merit and reduces complexity.

Finance Leases

For finance leases, the lessee will use the effective interest rate method to subsequently account for the lease liability. The lessee will amortize the ROU asset in a manner similar to that used for other nonfinancial assets; that is, the lessee would generally depreciate the ROU asset on a straight-line basis unless another systematic method would be appropriate. Together, these expense components would result in a front-loaded expense profile similar to that of a capital lease arrangement under current U.S. GAAP. Entities would separately present the interest and amortization expenses in the income statement.

Operating Leases

For operating leases, the lessee will also use the effective interest rate method to subsequently account for the lease liability. However, the subsequent measurement of the ROU asset would be linked to the amount recognized as the lease liability (unless the ROU asset is impaired). Accordingly, the ROU asset would be measured as the lease liability adjusted by (1) any accrued or prepaid rents, (2) unamortized initial direct costs and lease incentives, and (3) impairments of the ROU asset. As a result, the total lease payments made over the lease term would be recognized as lease expense (presented as a single line item) on a straight-line basis unless another systematic method is more appropriate.

Editor's Note: While the ASU discusses subsequent measurement of the ROU asset arising from an operating lease primarily from a balance sheet perspective, a simpler way to describe it would be from the viewpoint of the income statement. Essentially, the goal of operating lease accounting is to achieve a straight-line expense pattern over the term of the lease. Accordingly, an entity effectively takes into account the interest on the liability (i.e., the lease obligation consistently reflects the lessee's obligation on a discounted basis) and adjusts the amortization of the ROU asset to arrive at a constant expense amount. To achieve this, the entity first calculates the interest on the liability by using the discount rate for the lease and then deducts this amount from the required straight-line expense amount for the period (determined by taking total payments over the life of the lease, net of any lessor incentives, plus initial direct costs, divided by the lease term). This difference is simply "plugged" as amortization of the ROU asset to result in a straight-line expense for the period. By using this method, the entity recognizes a single operating lease expense rather than separate interest and amortization charges, although the effect on the lease liability and ROU asset in the balance sheet reflects a bifurcated view of the expense. Note, however, that the periodic lease cost cannot be less than the calculated interest on the lease liability (i.e. the amortization of the ROU asset, or "plug" amount, cannot be negative).

Impairment

Regardless of the lease classification, a lessee would subject the ROU asset to impairment testing in a manner consistent with other long-lived assets. If the ROU asset for a lease classified as an operating lease is impaired, the lessee would amortize the remaining ROU asset under the subsequent measurement requirements for a finance lease — evenly over the remaining lease term unless another systematic method would be appropriate. In addition, in periods after the impairment, a lessee would continue to present the ROU asset amortization and interest expense as a single line item.

Example 5 — Lessee Expense Recognition: Differences Between Subsequent-Measurement 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 ROU asset and liability to make lease payments is $38,000 at a discount rate of 8 percent.

The following table highlights the differences in accounting for the lease under the finance lease and operating lease approaches:

	Both Methods	Finance Lease Approach				Operating Lease Approach		
Year	Lease Liability[a]	Interest Expense <X>	Amortization Expense <Y>[b]	Total Lease Expense <X + Y>	ROU Asset	Lease Expense <Z>	Reduction in ROU Asset <Z – X> [c]	ROU 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	

[a] The effective-interest method is used to calculate the lease liability, regardless of the type of lease.

[b] Under the finance lease approach, the ROU asset would be amortized in the same manner as other nonfinancial assets (i.e., typically straight-line).

[c] Under the operating lease approach, amortization expense is calculated as the difference between lease expense and interest expense.

Lessor Accounting

After proposing multiple different amendments to lessor accounting, the FASB ultimately decided to make only minor modifications to the current lessor model. The most significant changes align the profit recognition requirements under the lessor model with those under the FASB's new revenue recognition requirements and amend the lease classification criteria to be consistent with those for a lessee. Accordingly, the ASU requires a lessor to use the classification criteria discussed above to classify a lease, at its commencement, as a sales-type lease, direct financing lease, or operating lease:

- *Sales-type lease* — The lessee effectively gains control of the underlying asset. The lessor would derecognize the underlying asset and recognize a net investment in the lease (which consists of the lease receivable and unguaranteed residual asset). Any resulting selling profit or loss would be recognized at lease commencement. Initial direct costs would be recognized as an expense at lease commencement unless there is no selling profit or loss. If there is no selling profit or loss, the initial direct costs would be deferred and recognized over the lease term. In addition, the lessor would recognize interest income from the lease receivable over the lease term.

  In a manner consistent with ASC 606, if collectibility of the lease payments plus the residual value guarantee is not probable, the lessor would not record a sale. That is, the lessor would not derecognize the underlying asset and would account for lease payments received as a deposit liability until (1) collectibility of those amounts becomes probable or (2) the contract has been terminated or the lessor has repossessed the underlying asset. Once collectibility of those amounts becomes probable, the lessor would derecognize the underlying asset and recognize a net investment in the lease. If the contract has been terminated or the lessor has repossessed the underlying asset, the lessor would recognize the deposit liability and recognize a corresponding amount of lease income.

- *Direct financing lease* — The lessee does not effectively obtain control of the asset, but the lessor relinquishes control. This would occur if (1) the present value of the lease payments and any residual value guarantee (which could be provided entirely by a third party or consist of a lessee guarantee coupled with a third-party guarantee)[14] represents substantially all of the fair value of the underlying asset and (2) it is probable that the lessor would collect the lease payments and any amounts related to the residual value guarantee(s). The lessor would derecognize the underlying asset and recognize a net investment in the lease (which consists of the lease receivable and unguaranteed residual asset). The lessor's profit and initial direct costs would be deferred and amortized into income over the lease term.
- *Operating lease* — All other leases are operating leases. In a manner similar to current U.S. GAAP, the underlying asset remains on the lessor's balance sheet and is depreciated consistently with other owned assets. Income from an operating lease would be recognized on a straight-line basis unless another systematic basis would be more appropriate. That is, a lessor would recognize uneven fixed lease payments (step payments) on a straight-line basis only when the payments are uneven for reasons other than to reflect or compensate for market rentals or market conditions (e.g., when there is significant front-loading or back-loading of payments or when there are rent-free periods in a lease). This may have a significant effect on a lessor's recognition of revenue for operating leases, particularly those related to real estate. Any initial direct costs (i.e., those that are incremental to the arrangement and would not have been incurred if the lease had not been obtained) would be deferred and expensed over the lease term in a manner consistent with the way lease income is recognized.

Editor's Note: Under the FASB's model, the immediate recognition of any profit in the income statement is precluded if control of the asset has not been transferred to the customer in accordance with ASC 606 (i.e., control would not have transferred for direct financing and operating leases). Profit can exist in a direct financing lease, though it would be deferred and recognized over the lease term rather than recognized immediately. In contrast, under IFRS 16, a lessor is not required to evaluate whether the arrangement would qualify as a sale under IFRS 15 in determining whether it can recognize a profit at lease commencement.

Example 6 — Lessor Profit Recognition

A lessor leases equipment to a lessee. The leased asset has a carrying amount of $20,000 and a fair value of $25,000 at lease commencement. The terms of the lease are as follows:

Terms	
Lease term	8 years
Annual lease payments	$3,500 due at the end of each year
Estimated useful life of the underlying asset	12 years
Rate the lessor charges the lessee (implicit rate in the lease)	6.98%
Estimated residual value at the end of the lease term	$7,000

Ownership of the underlying asset does not transfer by the end of the lease, and there is no bargain purchase option. In addition, the leased asset is not specialized, and it is probable that the lessor will collect the lease payments and any amounts related to the residual value guarantee.

[14] If the present value of lease payments plus a lessee-provided residual value guarantee represents substantially all of the fair of the underlying asset, the lessor would classify the lease as a sales-type lease.

Example 6 — Lessor Profit Recognition (continued)

Scenario 1 — Lessee Residual Value Guarantee (Sales-Type Lease)

As part of the lease contract, the lessee guarantees the full residual value of the underlying asset that is expected at the end of the lease.

Analysis

In this scenario, the lessor would conclude that the lease represents a sales-type lease. The lessee effectively gains control of the underlying asset because the present value of the lease payments and the residual value guarantee provided by the lessee represent all of the fair value of the underlying asset, which satisfies one of the five classification criteria for a sales-type lease (i.e., the present value of the lease payments and the residual value guarantee represent substantially all of the asset's fair value). Since control of the underlying asset has effectively transferred to the lessee, the lessor would be permitted to recognize the profit at lease commencement.

Scenario 2 — Third-Party Residual Value Guarantee (Direct Financing Lease)

As part of its risk management program, the lessor obtains a third-party guarantee that the residual value of the underlying asset at the end of the lease will be equal to $7,000.

Analysis

In this scenario, the lessor would conclude that the lease represents a direct financing lease because the lessee **does not** effectively obtain control of the underlying asset. This is because the present value of the lease payments made by the lessee does not represent substantially all of the fair value of the underlying asset (i.e., the present value of the lease payments represents only 84 percent of the fair value of the asset). However, since the present value of the lease payments and the third-party residual value guarantee represent all of the fair value of the underlying asset, and it is probable that the lessor will collect the lease payments and any amounts related to the residual value guarantee, the lease is considered a direct financing lease. Because control of the underlying asset has not effectively transferred to the lessee, the lessor **would not** be permitted to recognize the profit at lease commencement.

Accordingly, although the lessor would derecognize the underlying asset, it would be required to defer the profit and recognize the profit at a constant periodic rate (as part of interest income) over the term of the lease.

Comparison of Sales-Type Lease and Direct Financing Lease

The following table illustrates the accounting for the lease under the sales-type and direct financing approaches:

	Sales-Type Lease			Direct Financing Lease	
Year	Net Investment in Lease (Balance Sheet)	Interest Income	Selling Profit	Net Investment in Lease (Balance Sheet)	Interest Income
0	$ 25,000		$ 5,000	$ 20,000	
1	23,244	$ 1,744		18,953	$ 2,453*
2	21,366	1,622		17,778	2,326
3	19,356	1,491		16,459	2,181
4	17,207	1,350		14,978	2,019
5	12,447	1,200		13,315	1,837
6	14,907	1,040		11,448	1,633
7	9,815	868		9,353	1,404
8	7,000	685		7,000	1,147
Total		$ 10,000	$ 5,000		$ 15,000

* Under the direct financing lease model, the lessor would not recognize the selling profit at lease commencement because the lease does not transfer control of the underlying asset to the lessee. Instead, the lessor would recognize the selling profit through higher interest income over the term of the lease.

Effective Date

The new guidance is effective for public business entities for annual periods beginning after December 15, 2018 (i.e., calendar periods beginning on January 1, 2019), and interim periods therein. For all other entities, the ASU is effective for annual periods beginning after December 15, 2019 (i.e., calendar periods beginning on January 1, 2020), and interim periods thereafter. Early adoption is permitted for all entities. Further, an entity's ability to early adopt the new guidance would not be linked to its adoption of ASC 606.[15]

Editor's Note: Since early adoption is permitted, an entity could conceivably adopt the new standard for its year ended December 31, 2015, if its financial statements have not yet been issued or been made available for issuance. While an entity may believe that there are certain benefits to early adopting (e.g., the ability to derecognize assets and liabilities that resulted from deemed ownership under existing build-to-suit accounting guidance), it should carefully consider the implications of doing so. For example, it will need to ensure that it has systems, processes, and controls in place to appropriately implement the new guidance (see Appendix F for more information). Further, if an entity adopts the ASU before the issuance of any formal implementation guidance, its accounting for lease transactions may differ from that of its peers and thus the risk of regulatory scrutiny may increase.

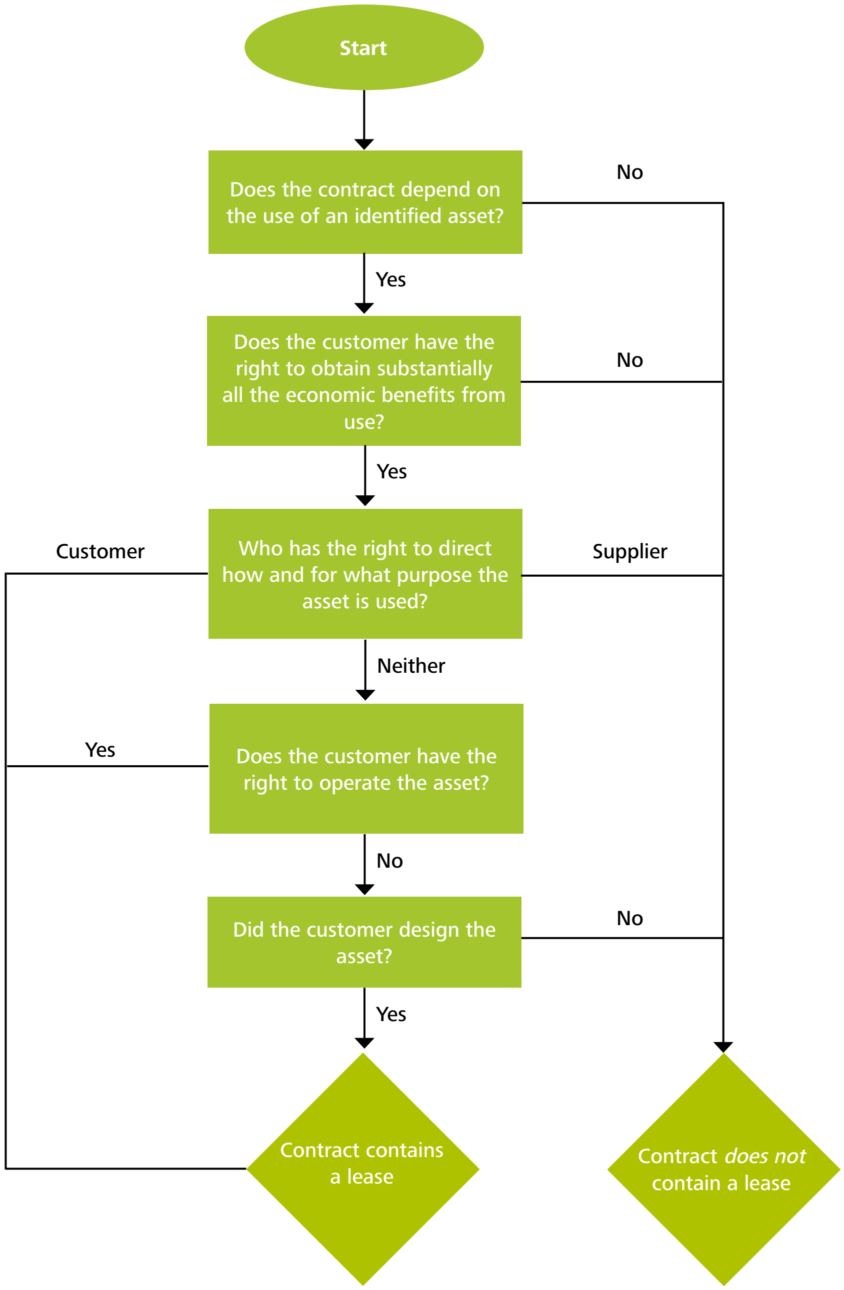
In addition, entities applying U.S. GAAP may adopt the new leases standard before they adopt the new revenue guidance (even though the new revenue standard has an earlier mandatory effective date). On the basis of discussions with the FASB staff, it is our understanding that such early adopters would be expected to apply the relevant guidance in the new revenue standard to the extent that it affects their lease accounting. They would wait to apply all other aspects of the new revenue standard until their full adoption of that standard.

[15] The effective date of IFRS 16 (the IASB's new leases standard) is similar to the FASB's effective date for public business entities. However, the IASB decided that an entity would only be allowed to early adopt IFRS 16 to the extent that the entity has also adopted IFRS 15 (the IASB's new revenue standard).

Appendix A — Evaluating Whether an Arrangement Is or Contains a Lease

The determination of whether an arrangement is or contains a lease is critical under the new requirements. If a lessee concludes that a contract is a service arrangement and not a lease, the lessee is not required to reflect the contract on its balance sheet. However, the lessee's balance sheet will need to reflect any lease arrangement that is not considered to be a short-term lease.

The following flowchart illustrates how to evaluate whether an arrangement is or contains a lease:



ASC 842-10-15-3 states that "[a] contract is or contains a lease if the contract conveys the right to control the use of identified [PP&E] (an identified asset) for a period of time in exchange for consideration." At the inception[16] of a contract, an entity should assess whether a contract is or contains lease. ASC 842-10-15-4 specifies that in determining whether the customer has the right to control the use of the identified asset, an entity would need to evaluate whether the customer has both:

- "The right to obtain substantially all of the economic benefits from use of the identified asset."
- "The right to direct the use of the identified asset."

[16] Lease inception is defined as the "date of the lease agreement or commitment, if earlier."

Use of an Identified Asset

Like current U.S. GAAP, the ASU requires a leased asset to be identifiable either explicitly (e.g., by a serial number) or implicitly (e.g., the only asset available to satisfy the contract). A distinct portion of a larger asset may be the subject of a lease (e.g., a floor of a building). However, a capacity portion of an asset would generally not meet the definition of a lease (e.g., 50 percent of an oil pipeline) unless the arrangement is for substantially all of the capacity of the asset. In addition, the ASU states that "[i]f the customer has the right to control the use of an identified asset for only a portion of the term of the contract," then only that portion of the term of the contract would be considered a lease.

Example A1 — Identified Asset

Scenario 1 — Contract Does Not Contain an Identified Asset

A company enters into a contract with a warehouse operator to store up to 1,000 pallets of spare parts inventory at one of the operator's warehouse locations for a three-year period. The operator's warehouse has capacity to store up to 10,000 pallets of inventory. During the contract period, the warehouse operator can use the remaining space in its warehouse for other storage needs. In addition, the warehouse operator can relocate the customer's pallets within the warehouse any time without incurring significant costs.

Because the customer does not have exclusive use of a specified portion of the warehouse, and the portion being used is not substantially all of the warehouse capacity, there is no identified asset. Although the contract specifies the amount of spare parts inventory that will be held, the warehouse operator can change the inventory's location within its warehouse at any time.

Scenario 2 — Contract Contains an Identified Asset

Assume the same facts as those above, except the 1,000 pallets represent substantially all of the capacity of the operator's warehouse, and the operator cannot relocate the inventory to a different facility.

Since the customer's storage requirement accounts for substantially all of the capacity of the operator's warehouse (more than 90 percent), the arrangement contains an identified asset.

Substitution Rights

An entity must also evaluate whether the supplier has the right to substitute the underlying asset with an alternative asset. If the supplier has substantive substitution rights, the asset in the arrangement would not be identified, and the arrangement would not be considered a lease. For a substitution right to be considered substantive, the following two conditions must be met:

- The supplier must have the "practical ability" to substitute the identified asset. The customer cannot prevent the supplier from substituting the asset, and alternative assets must be readily available to, or readily obtainable by, the supplier. A supplier's right (or obligation) to substitute alternative assets only if the asset is not operating properly would not meet this condition.
- The supplier must economically benefit from the substitution.

An entity should evaluate a substitution right by considering the facts and circumstances at the inception of the contract and would exclude from its assessment circumstances that are not likely to occur over the contract term. The entity should also consider the physical location of the asset. For example, it is more likely that the supplier will benefit from the substitution right if the identified asset is located at the supplier's rather than the customer's premises.

It may be difficult for a customer to determine whether the supplier's substitution right is substantive. For example, the customer may not know whether the substitution right gives the supplier an economic benefit. A customer would presume that a substitution right is not substantive if it is impractical to prove otherwise; accordingly, they must exercise significant judgment in making the determination.

Editor's Note: The requirement that a substitution right be economically beneficial to a supplier is a higher threshold than the requirements in current U.S. GAAP. Accordingly, we expect more arrangements to be subject to lease accounting under the new guidance.

Example A2 — Substantive Substitution Rights: Contract Does Not Contain a Substantive Substitution Right

Company A enters into an arrangement with Supplier B under which B will provide a customized Model 5000 copier to A for two years. Supplier B only has one customized Model 5000 copier. The arrangement allows B to replace the copier at will. However, if a replacement copier were needed, B would need several months to manufacture it. Since B only has one asset that can be used to satisfy the agreement with A and does not have the practical ability to substitute it, B's substitution right is not substantive.

Right to Control the Use of the Identified Asset

A lease differs from a service arrangement because in a lease, the customer effectively obtains control of the identified asset during the lease term. A customer has the right to control an asset if it has the right to do both of the following:

- Obtain substantially all of the economic benefits from the use of the identified asset.
- Direct the use of the identified asset.

Editor's Note: The notion of control under the new standard is closely aligned with that under the FASB's new revenue standard, which states that control is "the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset." However, the definition differs from the concept of control in consolidation guidance, under which design decisions are secondary to ongoing activities (e.g., those activities related to operations and maintenance). Design decisions and those related to operations and maintenance responsibilities have equal weight under the new leases standard.

Obtain Substantially All of the Economic Benefits From the Use of the Identified Asset

To control the use of an identified asset, the customer must have the right to obtain substantially all of the economic benefits from the use of the asset during the contract period. Economic benefits consist of direct or indirect benefits from the use of the asset (e.g., using, holding, or subleasing the asset) and include its primary output and its by-products (e.g., renewable energy credits from using the asset). Because a lease conveys only the right to use (and not ownership of) the underlying asset, benefits related to ownership of an asset (e.g., tax benefits) should not be included in the assessment of whether an arrangement contains a lease. Rather, this evaluation should be limited to those economic benefits resulting from the use of the asset during the contract period that can be realized from a commercial transaction with a third party.

Direct the Use of the Identified Asset

The evaluation of whether a customer has the right to direct the use of an identified asset should focus on the customer's ability to direct the activities that determine "how and for what purpose" the asset is used during the term of the contract. Factors to consider include whether the customer has the right to change (1) the type of output produced by the asset, (2) when the output is produced, (3) where the output is produced and (4) whether the output is produced. However, a requirement that protects the supplier's interest in the asset or related assets, or ensures that the customer complies with laws or regulations (e.g., a contract that specifies the maximum use of an asset or requires prudent operating practices), would not by itself prevent the customer from directing the use of the identified asset.

In situations in which neither the customer nor the supplier has the ability to determine "how and for what purpose" the asset is used during the contract period, the customer should consider whether the relevant decisions are predetermined by the contract or are based on the design of the underlying asset. If the relevant decisions are predetermined and the customer has the right to operate the asset or direct others to operate the asset — and the supplier cannot change the operating instructions — during the period of use, it is presumed that the customer has the ability to direct the use of the asset over the lease term. Similarly, if the customer's involvement in the design of the asset results in the predetermination of the most relevant decisions about "how and for what purpose" the asset is used over the contract term, then it is presumed that the customer controls the use of the asset.

Editor's Note: We anticipate that for certain industries the evaluation of control will require the use of significant judgment under the new standard, especially when the activities associated with the asset are predetermined. Although an entity may not have trouble determining whether the customer or supplier has control over the operating decisions related to the asset, the assessment of whether the customer designed the asset will often be more difficult given the different levels of influence a customer may have over the design decisions (e.g., siting, determining the technology to be used). Accordingly, an entity will need to use judgment when performing this evaluation.

For example, in a solar farm arrangement between a supplier and a utility company, the relevant decisions about how and for what purpose the assets are used are predetermined on the basis of the nature of the asset. Accordingly, the control evaluation would focus on whether the customer (the utility company) (1) has control over the operating decisions related to the asset (typically the operation and management will be performed by the asset owner (the supplier)) or (2) was involved in the decisions about the asset's design before contract inception.

Example A3 — Control of the Use of an Identified Asset

Scenario 1 — Customer Controls the Use of an Identified Asset

Customer A enters into a contract with Supplier B for the use of a specific ship for a four-year period. Supplier B is not permitted to substitute the ship. Customer A decides whether and what cargo will be transported and when and to which ports the ship will sail throughout the contract period, subject to certain restrictions. The restrictions prevent A from sailing the ship in waters where there is a high risk of piracy or from carrying hazardous materials as cargo. During the contract period, B operates and maintains the ship and is responsible for the safe passage of the cargo onboard the ship. Customer A is prohibited from hiring another operator for the ship during the term of the contract or operating the ship itself.

In this scenario, A has the right to control the use of the ship throughout the four-year contract period. That is, A has the right to obtain substantially all of the economic benefits from the use of the ship during the contract period through its exclusive use of the ship. Further, A has the right to direct activities related to the use of the ship because it decides where and when the ship will travel, what cargo it will carry, or whether it will be transporting cargo at any given time. While there are contractual restrictions about where the ship can sail and the nature of the cargo to be transported, these are protective rights and do not prevent A from having the right to direct the use of the asset.

Scenario 2 — Customer Does Not Control the Use of an Identified Asset

Customer A enters into a contract with Supplier B for the transportation of cargo from Greece to New York on a specified ship. The contract identifies the cargo to be transported on the ship as well as the route to be followed. During the contract term, B is responsible for the safe passage of the cargo and B's crew is responsible for operating and maintaining the ship (e.g., A cannot replace the crew under any circumstances).

Customer A **does not** have the right to control the use of the ship because it does not have the right to direct its use. That is, the activities related to the use of the ship during its trip from Greece to New York are predetermined in the contract. In addition, A does not have any decision-making rights about the operation of the ship during the period of use, nor was A involved in the ship's design.

Appendix B — Other Significant Provisions

Lease Modifications

Any change to the contractual terms and conditions of a lease that lead to a change in the scope of or consideration for the lease would be considered a lease modification. When assessing the changes, an entity should first evaluate whether the lease modification is to be accounted for as a separate contract (i.e., separately from the original lease). A lessee or lessor would account for a lease modification as a separate contract when, as a result of the modification, (1) the lessee is granted an additional ROU asset (physically distinct from the original ROU asset) and (2) the price of the additional ROU asset is commensurate with its stand-alone price (in the context of that particular contract). If the modification is considered a separate contract, the lessee or lessor would apply the new requirements to the separate contract.

Example B1 — Modification Resulting in a Separate Contract

Company A (lessee) enters into an arrangement to lease 15,000 square feet of retail space in a shopping mall for 20 years. At the beginning of year 10, A and the lessor agree to amend the original lease to include an additional 5,000 square feet of space adjacent to the existing space currently being leased when the current tenant vacates the property in 18 months. The increase in lease consideration as a result of the amendment is commensurate with the expected market rate for the additional 5,000 square feet of space in the shopping mall. Company A would account for this modification (i.e., the lease of the additional 5,000 square feet) as a separate contract because the modification provides A with a new ROU asset at a price that reflects its stand-alone price. While A would be required to disclose certain information about the lease modification, it would **not** be required to separately record any amounts in its statement of financial position until the separate lease's commencement date (i.e., 18 months from entering into the modification).

If the lease modification is **not a separate contract**, both the lessee and lessor would reassess the lease classification of the modified lease (by using the modified lease terms, including the discount rate as of the effective date of the modification). The lessee would account for the modification as follows:

Modification	Lessee's Accounting
Grants the lessee an additional ROU, changes the lease term (other than through the exercise of a contractual option), or results in a change to the lease consideration.	The lessee would use the updated lease payments and discount rate to revise the lease liability and would recognize any difference between the new lease liability and the old lease liability as an adjustment to the ROU asset.
Modification that reduces the scope of the original lease contract.	The lessee would adjust the lease liability by using the revised lease payments and an updated discount rate, derecognize a proportionate amount of the ROU asset, and recognize any difference as a gain/loss through earnings.

A lessee would subsequently account for the modified lease under the subsequent measurement guidance in the ASU (see discussion in the Subsequent Measurement section).

Example B2 — Modification Not Resulting in a Separate Contract

Company A (lessee) enters into an arrangement to lease 15,000 square feet in a shopping mall for 20 years. At the beginning of year 10, A and the lessor agree to amend the original lease by reducing the annual rental payments from $60,000 to $50,000 for the remaining 10 years of the agreement. Because the modification results in a change only to the lease consideration (i.e., the modification does not result in an additional ROU asset), A would remeasure its lease liability to reflect (1) a 10-year lease term, (2) annual lease payments of $50,000, and (3) A's incremental borrowing rate (or the rate the lessor charges the lessee if such rate is readily determinable) as of the modification's effective date. Company A would recognize the difference between the new and old lease liabilities as an adjustment to the ROU asset.

A lessor would account for a lease modification that is **not a separate contract** as follows:

Original Lease Classification	Lease Classification After the Modification	Lessor's Accounting
Operating lease	Operating lease	Any prepaid or accrued lease rentals are treated as a lease payment on the modified lease.
	Direct financing or sales-type lease	Any deferred rent liability or accrued rent asset is derecognized, and the selling profit or loss is adjusted accordingly (see the Lessor Accounting section for a discussion of the treatment of selling profit or loss for each type of lease).
Direct financing lease	Direct financing lease	The modification is accounted for prospectively by adjusting the discount rate.
	Sales-type lease	The profit or loss on the modification is the difference between the fair value of the underlying asset and the carrying value of the net investment in the lease immediately before the effective date of the modification.
	Operating lease	The modification is accounted for prospectively as an operating lease. The net investment in the lease is reclassified as the initial carrying value of the underlying leased asset.
Sales-type lease	Sales-type or direct financing lease	The modification is accounted for prospectively by adjusting the discount rate.
	Operating lease	The modification is accounted for prospectively as an operating lease. The net investment in the lease is reclassified as the initial carrying value of the underlying leased asset.

Contracts That Contain Multiple Components

An entity is required to identify the lease and nonlease components of a contract that contains a lease. A contract may also contain multiple lease components. The right to use an underlying asset is considered a separate lease component if (1) a lessee can benefit from the use of the underlying asset either on its own or with other resources that are readily available **and** (2) the underlying asset is not highly dependent on or highly interrelated[17] with other assets in the arrangement. Accordingly, a contract may include multiple lease components for different underlying assets.

Notwithstanding its requirement related to identifying lease components, an entity must account for the right to use land and other assets separately unless the effect of doing so would be insignificant to the overall accounting for the transaction (e.g., if a lease includes both land and a building component, and the entity concludes that each component would be classified as an operating lease, accounting for the two lease components together would be reasonable since the overall impact of accounting for the components together would be insignificant).

Editor's Note: When evaluating whether an activity should be considered a separate nonlease component, an entity should consider whether the activity transfers a separate good or service to the lessee. A component includes only those items or activities that transfer a good or service to the lessee. For example, in a real estate lease, maintenance services (including common-area maintenance services or CAM) and utilities paid for by the lessor but consumed by the lessee would be separate nonlease components because the lessee would have been required to otherwise contract for these services separately. However, payments for property taxes or insurance would most likely be considered part of the lease component because they do not transfer a separate good or service to the lessee. Such treatment could have the effect of inflating the lease liability since it would include amounts that are currently considered executory costs. From a practical standpoint, however, such amounts are frequently variable and therefore would not be included in the measurement of the lease liability.

[17] The ASU states that "[a] lessee's right to use an underlying asset is highly dependent on or highly interrelated with another right to use an underlying asset if each right of use significantly affects the other."

When a contract includes both lease and nonlease components, an entity is required to allocate the consideration in the contract to the various elements (except when a lessee is applying the practical expedient discussed below). The ASU provides separate guidance on how lessees and lessors should allocate these amounts.

Allocation by Lessees

Lessees need to first consider whether the stand-alone prices of the various components are observable. If each component has an observable stand-alone price, the lessee would base its allocation on the relative stand-alone price of each component. If only certain components have observable stand-alone prices, the lessee is permitted to estimate stand-alone prices by maximizing observable information for those items that do not have an observable stand-alone price. In addition, a lessee would allocate initial direct costs to the various components in a manner similar to its allocation of lease payments to each component.

Lessees are permitted to elect, as an accounting policy by class of underlying asset, not to separate lease components from nonlease components and instead account for the entire contract as a single lease component. However, when applying this election, a lessee would not be permitted to combine multiple lease components.

Allocation by Lessors

A lessor must consider the allocation guidance in ASC 606 to determine how to allocate the payments between the lease and nonlease components. That guidance allows a lessor to use an estimated selling price when no observable price exists. In addition, a lessor would allocate any capitalized costs, such as initial direct costs, to the components to which the costs are related.

Reallocation

Both lessees and lessors are required to reallocate the consideration in a contract when the contract is modified and the modification is not considered a separate contract. Lessees are also required to reallocate the consideration in the contract upon a reassessment of the lease term or a change in the likelihood that a purchase option will be exercised.

Contract Combinations

An entity is required to combine two or more contracts entered into at or near the same time with the same counterparty if any of the following criteria are met:

- The contracts are negotiated as a package with a single commercial objective.
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract.
- The rights or some of the rights to use underlying assets conveyed in the contracts are a single lease component.

This guidance is generally consistent with the contract combination guidance in ASC 606.

Initial Direct Costs

In a manner consistent with the guidance in ASC 606, initial direct costs for both lessees and lessors would include only those costs that are incremental to the arrangement and would not have been incurred if the lease had not been obtained. This definition is considerably more restrictive than that under current requirements. For example, commissions paid and payments made to existing tenants to obtain the lease are considered initial direct costs, whereas allocated internal costs and costs to negotiate and arrange the lease agreement that would have been incurred regardless of lease execution (e.g., professional fees such as those paid for legal and tax advice) are not.

For sales-type leases, initial direct costs are recognized as an expense at lease commencement unless there is no selling profit or loss on the transaction. If there is no selling profit or loss, the initial direct costs are deferred and recognized over the lease term. For direct financing leases, a lessor would defer and include all initial direct costs in the initial measurement of the lease receivable. For operating leases, a lessor would defer the initial direct costs and amortize them as expenses over the term of the lease.

A lessee would include all initial direct costs in its initial measurement of the ROU asset.

Sale-and-Leaseback Transactions

The seller-lessee in a sale-and-leaseback transaction must evaluate the transfer of the underlying asset (sale) under the requirements in ASC 606 to determine whether the transfer qualifies as a sale (i.e., whether control has been transferred to the customer). The existence of a leaseback by itself would not indicate that control has not been transferred (i.e., it would not preclude the transaction from qualifying as a sale) unless the leaseback is classified as a finance lease. In addition, if the arrangement includes an option for the seller-lessee to repurchase the asset, the transaction would not qualify as a sale unless (1) the option is priced at the fair value of the asset on the date of exercise and (2) alternative assets exist that are substantially the same as the transferred asset and are readily available in the marketplace.

If the transaction does not qualify as a sale, the seller-lessee and buyer-lessor would account for the transaction as a financing arrangement (i.e., the buyer-lessor would account for its payment as a financial asset and the seller-lessee would record a financial liability).

Editor's Note: The ASU will significantly affect equipment sale-and-leaseback arrangements that include purchase options. Under current U.S. GAAP, a sale-and-leaseback transaction of equipment that includes a repurchase option may not result in a failed sale if there are no economic penalties reasonably ensuring that the repurchase option will be exercised. By contrast, under the ASU, any arrangement that includes a substantive repurchase option (e.g., a fixed-price purchase option) would be considered a failed sale because control of the underlying asset is not transferred to the purchaser.

Leaseback Accounting

If the transaction qualifies as a sale, the leaseback is accounted for in the same manner as all other leases (i.e., the seller-lessee and buyer-lessor would account for the leaseback under the new lessee and lessor accounting guidance, respectively).

Gain or Loss Recognition

If a transaction is based on "market" terms, the seller-lessee would immediately recognize the full amount of any gain or loss resulting from the sale (in a manner consistent with the treatment of sales of nonfinancial assets that do not involve a leaseback).[18] However, a transaction based on "off-market" terms would affect the calculation of the gain or loss. Specifically, the ASU requires a seller-lessee and a buyer-lessor to recognize off-market adjustments if there is a difference between (1) the sales price and fair value of the asset sold or (2) the present value of the contractual lease payments and the present value of the lease payments at fair market value. The seller-lessee would account for any difference either as an adjustment to the ROU asset or additional financing from the buyer-lessor that is separate from the lease liability. The buyer-lessor would recognize any difference as a prepayment of rent or additional financing to the seller-lessee that is separate from the lease receivable.

Accounting for Related-Party Leases

Lessees and lessors are required to account for related-party leasing arrangements on the basis of the legally enforceable terms and conditions of the lease rather than the substance of the arrangement. This is a significant change from current U.S. GAAP, under which a lessee and lessor would consider the substance of the contract as well as its legal form. The ASU requires a related-party lease to be accounted for in a manner similar to a lease between unrelated parties. Lessors and lessees are also required to disclose the information required by ASC 850 for all related-party lease arrangements.

Sublease Accounting

When the original lessee subleases the leased asset to an unrelated third party, the lessee becomes the intermediate lessor in the sublease arrangement. As the intermediate lessor of a leased asset, the entity would determine the classification of the sublease independently from its determination of the classification of the original lease (i.e., the head lease). Under the ASU, the intermediate lessor would classify the sublease on the basis of the underlying asset[19] (i.e., it would assess the term of the sublease

[18] By contrast, a seller-lessee applying IFRSs would only recognize gains resulting from the sale to the extent of the amount associated with the residual asset.

[19] The accounting for subleases under the new U.S. GAAP model differs significantly from that under IFRSs, which require the classification to be based on the remaining economic life of the ROU asset.

relative to the remaining economic life of the underlying asset). When evaluating lease classification and measuring the net investment in a sublease classified as a sales-type or direct financing lease, the original lessee (as a sublessor) should use the rate implicit in the lease if it is determinable. If the implicit rate is not determinable, the original lessee would use the discount rate that it used to determine the classification of the original lease.

In addition, offsetting is generally prohibited on the balance sheet and income statement unless the arrangement meets the offsetting requirements of ASC 210-20.

Example B3 — Accounting for a Sublease Under ASC 842

Company A, as lessee, entered into a building lease with a 30-year term. The building has a depreciable life of 40 years. At the end of year 5, A entered into an agreement with Company B under which B would sublease the building for 20 years.

As lessor, A would account for the lease to B (the sublease) as an operating lease because the term of the sublease is not for a major part of the remaining life of the *underlying asset* of the sublease (i.e., the sublease term of 20 years represents only 57 percent of the remaining 35-year life of the building), and A has concluded that no other classification criteria would result in the transfer of control of the underlying asset.

Build-to-Suit Arrangements

The ASU does not carry forward the requirements in current U.S. GAAP on lessee involvement in asset construction or "build-to-suit" leases. That guidance has long been criticized for being difficult to apply and punitive in nature. However, the new standard stipulates that an asset controlled[20] by a lessee during the construction period would be subject to sale-and-leaseback accounting upon completion of construction (i.e., the asset is effectively owned by the lessee during the construction period and is effectively sold — to the legal owner — and leased back upon completion of construction). The ASU provides guidance on how to account for certain costs incurred by the lessee related to the construction or design of the underlying asset if the lessee does not control the asset under construction. Costs incurred for goods or services provided to the lessee as well as other construction-related outflows or inflows for items such as loans, guarantees, and sales of component parts would be accounted for in accordance with other ASC topics.

Editor's Note: The ASU's Basis for Conclusions notes that (1) a lessee can be, and thus should assess whether it is, the owner of an asset under construction before lease commencement and (2) the assessment should be based on control (i.e., when the lessee controls the asset under construction). This is a departure from the requirements under current U.S. GAAP, which focus on construction risk assumed by a lessee, and is another example of the Board's effort to align the guidance on leases and revenue when appropriate. ASC 842-40 provides indicators of a lessee's control of an underlying asset that is under construction. Two of those indicators closely mirror those used by suppliers under ASC 606 to determine whether customers gain control of their work as they perform (i.e., as construction progresses). Under ASC 606, when a supplier's "performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced," the supplier is satisfying its performance obligation over time. A lessee that controls an asset as it is created or enhanced by the supplier's performance owns the asset throughout the work in process and should therefore apply the sale-and-leaseback accounting guidance in ASC 842-40 upon lease commencement. ASC 842-40 also provides indicators of legal ownership of the asset under construction as well as control, through lease or ownership, of the underlying land.

However, it is important to differentiate control of an asset during construction from control of *the right to use an asset* during construction. The latter reflects the lease of an asset under construction, an arrangement that is specifically excluded from the scope of ASC 842.

Leasehold Improvements

In a manner consistent with current U.S. GAAP, a lessee would generally capitalize a leasehold improvement as a separate asset and amortize it over the shorter of its useful life and the remaining lease term. However, a lessee would amortize a leasehold improvement over its useful life (even if such life is longer than the lease term) if (1) the lease transfers ownership of the underlying

[20] ASC 842-40-55-5 provides indicators for lessees to consider when determining whether the lessee controls the underlying asset being constructed.

asset to the lessee at the end of the lease term or (2) it is reasonably certain that the lessee will exercise an option to purchase the underlying asset.

A leasehold improvement acquired in a business combination will be amortized over the shorter of its useful life or remaining lease term as of the acquisition date.

Accounting for Leases at a Portfolio Level

Lessees and lessors are permitted to apply the new lease guidance at a portfolio level if the resulting accounting would not be significantly different from that achieved when they apply the guidance on an individual-lease basis. This would apply to transition accounting as well as on a go-forward basis and is expected to be particularly useful for companies with a significant number of leases with similar economic characteristics. Applying the lease guidance at a portfolio level may facilitate the accounting when judgments or estimates are required under the model (e.g., using a single discount rate for an entire portfolio of leases may be appropriate if the resulting accounting would not be materially different from that resulting from the application of a unique discount rate to each individual lease).

Leveraged Lease Accounting

On the effective date of the new standard, leases previously classified as leveraged leases under ASC 840 would be subject to the guidance in ASC 842-50. This approach is generally consistent with the legacy accounting requirements for leveraged leases and effectively grandfathers that guidance. If a leveraged lease is modified after the ASU's effective date, it would be accounted for as a new lease under the standard's lessee and lessor models. Entities would not be permitted to account for any new lease arrangements as leveraged leases after the ASU's effective date.

Business Combinations

The ASU requires the acquiring entity in a business combination to retain the acquiree's previous lease classification. However, if the business combination results in changes to the contractual terms and conditions of the lease (i.e., a modification) and the modification is not accounted for as a separate contract, the acquirer would classify the lease on the basis of the modified terms. The initial measurement would be as follows:

- *Acquiree is a lessee* — In a manner similar to the short-term lease scope exception, an acquiring entity may, as an accounting policy election by asset class, choose not to recognize assets or liabilities related to acquired leases that have a remaining lease term of 12 months or less as of the acquisition date. For all other leases, the acquiring entity must initially measure (1) the lease liability at the present value of the remaining lease payments (as if the acquired lease were a new lease of the acquiring entity as of the acquisition date) and (2) an ROU asset at the same amount, adjusted to reflect favorable or unfavorable terms of the lease relative to market terms.
- *Acquiree is a lessor* — The initial measurement is based on the classification of the acquired lease:
    - *Operating lease* — The acquiring entity will recognize (separately from the underlying leased asset) (1) an intangible asset if the terms of the acquired lease are favorable relative to market terms and (2) a liability if the terms are unfavorable relative to market terms.
    - *Sales-type or direct financing leases* — The acquiring entity will measure its net investment in the lease (total lease receivable and unguaranteed residual asset) at the fair value of the underlying asset as of the acquisition date. The terms of the lease (favorable or unfavorable) relative to market terms should be considered in the calculation of the underlying asset's acquisition-date fair value.

Appendix C — Presentation Requirements

ASU 2016-02 contains presentation requirements for lessees and lessors that are based on the classification of the lease agreement.

Lessee Presentation Requirements

Statement of Financial Position

An entity is required to present in the statement of financial position, or disclose in its notes to the financial statements, ROU assets and liabilities resulting from finance leases and operating leases. These assets and liabilities should be presented or disclosed separately from each other and from other assets and liabilities. Further, the lessee is required to separately present the current and noncurrent portions of the ROU asset and lease liability.

Editor's Note: The ASU's separate presentation requirement for finance and operating leases may be viewed favorably by preparers because it may reduce an entity's exposure to potential debt covenant violations that could have resulted if all lease liabilities were required to be characterized as debt. See Appendix F for more information.

Statement of Comprehensive Income

Lessees would present the expense related to their lease arrangements as follows:

- *Finance leases* — Interest expense on the lease liability and amortization of the ROU asset would be presented in a manner consistent with the lessee's presentation of interest expense related to its other liabilities and depreciation or amortization of similar assets, respectively. Variable lease payments would be included as an expense in the lessee's income from continuing operations.
- *Operating leases* — Lease expense is included in the lessee's income from continuing operations as a single lease expense amount.

Editor's Note: Entities will need to consider the effect of their lease classification on certain financial statement metrics and non-GAAP measures, such as earnings before interest, taxes, depreciation, and amortization (EBITDA). The interest and amortization expense resulting from a finance lease would typically be excluded from an entity's calculation of EBITDA. By contrast, the entity's EBITDA calculation would include its expense resulting from an operating lease (which is classified as an operating expense in the statement of comprehensive income). Entities should also consider the effects of these changes on other business arrangements such as, for example, employee compensation plans tied to earnings metrics.

Statement of Cash Flows

The presentation of cash flows generally depends on whether the lease is a finance lease or an operating lease:

- *Finance leases* — Payments of principal and interest are presented as cash outflows from financing and operating activities, respectively.
- *Operating leases* — Operating lease payments are presented as cash outflows from operating activities.

However, irrespective of lease classification, both variable lease payments that are not included in the lease liability and payments on short-term leases are presented as cash outflows from operating activities. Further, any cash flows resulting from lease payments used to bring another asset to its intended location for its intended use would be classified in investing activities.

Lessor Presentation Requirements

Statement of Financial Position

A lessor's presentation of a lease agreement depends on whether the lease is a sales-type lease, direct financing lease, or an operating lease:

- *Sales-type and direct financing leases* — The net investment in a lease is separately presented in the statement of financial position.
- *Operating leases* — The underlying asset subject to an operating lease is presented in accordance with other ASC topics (e.g., ASC 360).

Statement of Comprehensive Income

All income resulting from a lease is separately presented in the statement of comprehensive income or disclosed in the notes. An entity that does not separately present lease income in the statement must disclose where in the statement it is included. In addition, any profit or loss resulting from a lease should be recognized at lease commencement in a manner consistent with the lessor's business model (e.g., gross revenue and cost of goods as opposed to profit and loss in a single line item).

Editor's Note: Because the ASU allows a lessor to present profit or loss resulting from a lease in a manner consistent with its business model, the lessor may present such amounts on a gross or net basis. This presentation flexibility is designed to reflect institutions' various business models. For example, a manufacturing entity may enter into a leasing arrangement as opposed to selling directly to customers, whereas a financial institution may enter into a leasing arrangement as a means of providing financing. The standard also acknowledges that a lessor with multiple business models could present profit or loss resulting from leases on a gross or net basis depending on the particular model the lease is related to.

Statement of Cash Flows

Regardless of lease classification, cash inflows related to a lease are presented as cash inflows from operating activities.

Appendix D — Disclosure Requirements

The objective of ASU 2016-02's disclosure requirements is to help financial statement users understand the amounts, timing, and uncertainties of cash flows related to a lease. An entity is required to disclose certain qualitative and quantitative information about its leases, judgments used in applying the leasing guidance, and the related amounts recognized in the financial statements.

Lessee Disclosures

Qualitative Disclosures

A lessee should disclose:

- Information about the nature of its leases and subleases (general description of the lease, variable lease payments, renewal or termination options, residual value guarantees, and restrictions imposed by the lease).
- Leases that have not yet commenced but give the lessee significant rights or impose significant obligations, including the nature of any involvement in the design or construction of the underlying asset.
- Significant assumptions and judgments used in applying the leases standard.
- Main terms and conditions of any sale-and-leaseback transactions.
- Lease transactions with related parties.
- Accounting policy regarding short-term leases.
- Accounting policy election of the practical expedient not to separate lease and nonlease components.

Quantitative Disclosures

A lessee should disclose the following amounts for each period presented (regardless of whether the amounts are capitalized as part of another asset):

- Finance lease costs (i.e., amortization of the ROU asset and interest on the lease liability).
- Operating lease costs.
- Short-term lease costs (except for leases with a term of one month or less).
- Variable lease costs.
- Sublease income, disclosed on a gross basis.
- Gain or loss resulting from sale-and-leaseback transactions.

A lessee should disclose the following amounts separately for its operating and finance leases:

- Separate maturity analyses of its operating lease liabilities and finance lease liabilities (undiscounted cash flows for each of the next five years and a total of the amounts for the remaining years, reconciled to the amounts presented in the statement of financial position).
- Cash paid for amounts included in its determination of lease liabilities (segregated between operating and financing cash flows).
- Supplemental noncash information on lease liabilities arising from obtaining ROU assets.
- Weighted-average remaining lease term.
- Weighted-average discount rate.

For a complete list of the disclosure requirements for lessees, see ASC 842-20-50 and ASC 842-40-50 in the ASU.

Lessor Disclosures

Qualitative and Quantitative Disclosures

A lessor is required to disclose certain qualitative and quantitative information, including:

- Information about the nature of its leases (general description of the lease, variable lease payments, renewal, purchase or termination options).
- Significant assumptions and judgments used in the application of leases guidance.
- Lease transactions with related parties.
- A tabular disclosure of lease-related income, including:
    - Profit and loss recognized at lease commencement for sales-type and direct financing leases.
    - Interest income.
    - Income from variable lease payments not included in the lease receivable.
- The components of the net investment in sales-type and direct financing leases, including the carrying amount of the lease receivable, the unguaranteed residual asset, and any deferred profit on direct financing leases.
- Information about how the entity manages its exposure to risk associated with the residual value of its leased assets.
- A maturity analysis for operating lease payments and a separate maturity analysis for the lease receivable (sales-type and direct financing leases). The maturity analysis should show the undiscounted cash flows to be received in each of the next five years after the reporting date, and a total of the amounts for the years thereafter. The maturity analysis of the lease receivable should be reconciled to the lease receivable balance.
- The information required by ASC 360 for all assets that are subject to an operating lease, presented separately from similar owned assets.

For a complete list of the disclosure requirements for lessors, see ASC 842-30-50 and ASC 842-50-50 (on leveraged lea"eses) in the ASU.

Appendix E — Transition

Transition Requirements

Lessees and lessors[21] are required to use a modified retrospective transition method for existing leases. Accordingly, they would apply the new accounting model for the earliest year presented in the financial statements. The application of this approach is directly linked to the current lease classification under ASC 840 and the new lease classification under ASC 842.

Lessee Requirements

The following table summarizes ASU 2016-02's modified retrospective transition requirements for lessees:

		Current U.S. GAAP (ASC 840)	
		Operating Lease	Capital Lease
New Model (ASC 842)	Operating lease	• Recognize an ROU asset and lease liability at the later of (1) the beginning of the earliest year presented or (2) the lease commencement date. • Measure a lease liability as the present value of the remaining lease payments and expected residual value guarantee discounted by using a rate determined at the later of (1) the beginning of the earliest year presented or (2) the lease commencement date. • Measure an ROU asset equal to the lease liability, adjusted for prepaid/accrued rent, unamortized initial direct costs, impairment of the ROU asset, and the carrying amount of any liability recognized under ASC 420 (i.e., related to exit or disposal cost obligations). • Write off as an adjustment to equity any unamortized initial direct costs that do not meet the ASU's definition of initial direct costs.	• Derecognize the capital lease asset and lease obligation at the later of (1) the beginning of the earliest year presented or (2) the lease commencement date. Any difference between the amounts derecognized would be accounted for similarly to prepaid or accrued rent. • Recognize an ROU asset and lease liability by using (1) the ASU's initial measurement guidance for leases entered into after the beginning of the earliest period presented or (2) the ASU's subsequent measurement guidance that applies to leases entered into before the beginning of the earliest year presented. • Write off as an adjustment to equity any unamortized initial direct costs that do not meet the ASU's definition of initial direct costs.
New Model (ASC 842)	Finance lease	• Recognize an ROU asset and lease liability at the later of (1) the beginning of the earliest year presented or (2) the lease commencement date. • Measure a lease liability as the present value of the remaining lease payments and expected residual value guarantee discounted by using a rate determined at the later of (1) the beginning of the earliest year presented or (2) the lease commencement date. • Measure an ROU asset equal to a proportion of the lease liability as of the commencement date, adjusted for the carrying amount of previously recognized prepaid or accrued lease payments and the carrying amount of liabilities recognized under ASC 420. The proportionate amount is based on the remaining lease term (as of the beginning of the earliest period presented) relative to the total lease term. • Write off as an adjustment to equity any unamortized initial direct costs that do not meet the ASU's definition of initial direct costs.	• Recharacterize the capital lease asset as an ROU asset as of the later of (1) the beginning of the earliest year presented or (2) the lease commencement date. • Include in the ROU asset established at transition any unamortized initial direct costs that meet the ASU's definition of initial direct costs. • Write off as an adjustment to equity any unamortized initial direct costs that do not meet the definition of such costs in ASC 842 and are not included in the measurement of the capital lease asset under ASC 840.

Note that there are additional considerations under ASC 842-10-65-1 for modifications of a lease that occur on or after the standard's effective date and do not result in a separate contract.

[21] Lessors must account for leveraged leases under the requirements in ASC 842-50, which are similar to the current requirements in ASC 840 for leveraged leases. However, if the leveraged lease is modified, it would be accounted for as a new lease.

Example E1 — Lessee Transition

A lease with the following terms was accounted for as an operating lease under current U.S. GAAP:

Lease term:	10 years (January 1, 2013, through December 31, 2022).
Adoption date:	January 1, 2019 (beginning of year 7 (4 years remaining)).
Lease payments:	$100 in years 1 through 5; $120 in years 6 through 10 (payments occur at the end of the year).
Discount rate:	4 percent (January 1, 2017).

The table below illustrates the adjustments made to the financial statements as a result of the adoption of the ASU if (1) the lease continues to be classified as an operating lease and (2) the lease is classified as a finance lease.

	Operating Lease				Finance Lease			
	Lease Liability	ROU Asset	Reversal of Straight-Line Accrual	Retained Earnings/ Net Income	Lease Liability	ROU Asset	Reversal of Straight-Line Accrual	Retained Earnings/ Net Income
Adjustment on 1/1/2017 (earliest period presented)	$ 610[(a)]	$ 570[(b)]	$ 40[(g)]	$ 0	$ 610[(a)]	$ 490[(c)]	$ 40[(g)]	$ 80
12/31/2017	534[(d)]	484[(e)]		110	534[(d)]	408[(f)]		106
12/31/2018	436[(d)]	396[(e)]		110	436[(d)]	326[(f)]		103

[(a)] The lease liability is calculated as the present value of the remaining lease payments ($120 for 5 years and one year at $100 discounted at 4 percent).

[(b)] The ROU asset under the operating lease model is calculated at the initial amount of the lease liability adjusted for the previously recorded straight-line accrual of $40 (i.e., $570 = $610 − $40).

[(c)] The ROU asset under the financing approach is calculated in proportion (6 of 10 years remaining) to the lease liability as of the commencement date (present value of all lease payments or $884), reduced by the straight-line accrual of $40 (i.e., $490 = [($884 × 6 ÷ 10) − $40)].

[(d)] The lease liability is subsequently calculated by using the effective interest method.

[(e)] The ROU asset is subsequently measured at an amount equal to the lease liability, adjusted for the accrued lease expense of $50 on 12/31/2017 and $40 at 12/31/2018. This results in a straight-line expense of $110 per year.

[(f)] The ROU asset is subsequently amortized on a straight-line basis ($490 over 6 years or $82 per year).

[(g)] This amount represents the straight-line lease accrual that results from recording a straight-line annual lease expense of $110 per year for the four years from 2013 to 2016 compared to lease payments totaling $400 during that period.

Lessor Requirements

The following table summarizes the ASU's modified retrospective transition requirements for lessors:

	Current U.S. GAAP (ASC 840)	
New Model (ASC 842)	**Operating Lease**	**Direct Financing or Sales-Type Lease**
Operating lease	• Continue to recognize the carrying amount of the underlying asset and any lease assets or liabilities at the later of (1) the initial application date or (2) the lease commencement date. • Write off as an adjustment to equity any unamortized initial direct costs that do not meet the ASU's definition of initial direct costs.	As of the later of (1) the beginning of the earliest period presented or (2) the lease commencement date: • Recognize an underlying asset at the carrying amount that would have existed had the lease been classified as an operating lease under ASC 840. • Derecognize the carrying amount of the net investment in the lease. • Recognize as an adjustment to equity the difference between the newly recognized asset and the derecognized net investment.
Direct financing or sales-type lease	As of the later of (1) the beginning of the earliest period presented or (2) the lease commencement date: • Derecognize the carrying amount of the underlying asset. • Recognize a net investment in the lease as if the lease had been accounted for as a direct financing lease or sales-type lease since lease commencement. • Recognize as an adjustment to equity the difference between the newly recognized net investment and the derecognized asset.	• Continue to recognize a net investment in the lease, at the later of (1) the beginning of the earliest period presented or (2) the lease commencement date, at the carrying amount at that date. • Before the effective date of the new guidance, the lease should be accounted for under ASC 840. • Beginning on the effective date, the lease should be accounted for under the ASU.

Note that there are additional considerations under ASC 842-10-65-1 for modifications of a lease that occur on or after the standard's effective date and do not result in a separate contract.

Transition Relief

The ASU offers relief from implementing the standard's transition provisions by permitting an entity (lessee or lessor) to elect not to reassess:

- Whether any expired or existing contract is a lease or contains a lease.
- The lease classification of any expired or existing leases.
- Initial direct costs for any existing leases.

An entity that elects transition relief is required to adopt all three relief provisions and is prohibited from applying the relief on a lease-by-lease basis. In addition, the entity must disclose that it has elected the transition relief package. Separately, the entity is also allowed to use hindsight in its evaluation of the lease term (e.g., renewal, termination, and purchase options for existing leases).

Editor's Note: Electing the transition relief may significantly reduce the burden of adopting the new standard since entities would not be required to revisit old lease contracts and related documentation to reevaluate whether such arrangements meet the new definition of a lease or how to classify them under the ASU. Such an election does not, however, relieve an entity from its obligation to address any errors that may have resulted from the misapplication of past accounting (e.g., improperly accounting for an arrangement as a service rather than a lease or inappropriately classifying a lease as an operating lease rather than a capital lease).

Sale-and-Leaseback Transactions

An entity is required to reassess its conclusion that a sale that was part of a failed sale-and-leaseback transaction continues to be disqualified from the application of sale accounting under ASC 606 upon transition as long as the transaction is still considered to be a failed sale as of the effective date of the new lease accounting guidance. In addition:

- The seller in a sale-and-capital-leaseback transaction is required to recognize any deferred gain or loss that exists as of the later of (1) the earliest period presented or (2) the date of the sale of the underlying asset as follows:
    - If the underlying asset is land only, on a straight-line basis over the remaining lease term.
    - If the underlying asset is not land only and the leaseback is a finance lease, in proportion to the amortization of the ROU asset.
    - If the underlying asset is not land only and the leaseback is an operating lease, in proportion to the total lease cost.
- The seller in a sale-and-operating-leaseback transaction is required to recognize any deferred gain or loss resulting from off-market terms as an adjustment to the leaseback ROU asset (loss) or lease liability (gain) as of the date of initial application. The seller is required to recognize any deferred gain or loss not resulting from off-market terms as a cumulative-effect adjustment to opening equity (if the transaction occurred before the earliest year presented) or earnings in the comparative period (if the transaction occurred within one of the comparative periods presented).

Build-to-Suit Lease Arrangements

The ASU supersedes current guidance on build-to-suit arrangements. A lessee must apply the modified retrospective transition approach to such arrangements. Accordingly, it should derecognize assets and liabilities from build-to-suit transactions under ASC 840 (those assets and liabilities that arose because the lessee was deemed the owner during construction and could not be derecognized under the legacy sale-and-leaseback requirements) as of the later of (1) the earliest financial statement period presented or (2) the date on which the entity was deemed the accounting owner. Any differences between the assets and liabilities derecognized would be recorded as an adjustment to equity on that date. Further, if the construction period ended before the earliest comparative period presented, and the transaction subsequently qualified for and was accounted for as a sale-and-leaseback transaction, the entity should consider the general lessee transition requirements.

Business Combinations

On the effective date of the new guidance, any assets and liabilities related to favorable or unfavorable terms of an operating lease that resulted from prior business combinations would be derecognized upon transition (except for those arising from operating leases under which the entity is a lessor). A lessee would adjust the carrying amount of the ROU asset by a corresponding amount. By contrast, a lessor would make a corresponding adjustment to equity at the beginning of the earliest comparative period presented for its leases that are classified as sales-type or direct financing under ASC 840.

Appendix F — Implementation Considerations

Application of Judgment and Estimation

Entities must apply judgment and make estimates under a number of the new (as well as current) leases requirements. Judgment is often required in the assessment of a lease's term, which would affect whether the lease qualifies for the short-term exemption and therefore for off-balance-sheet treatment. In addition, since almost all leases will be recognized on the balance sheet, an entity's judgment in distinguishing between leases and services becomes more critical under the new guidance.

Editor's Note: In particular, upon transition, entities will need to recognize ROU assets and lease obligations by using an appropriate discount rate on the date of transition (see Appendix E for additional considerations). Compliance with this requirement may be difficult for entities with a significant number of leases since they will need to identify the appropriate incremental borrowing rate for each lease on the basis of factors associated with the underlying lease terms (e.g., lease tenor, asset type, residual value guarantees). In other words, entities would not be permitted to use the same discount rate for all of their leases unless the leased assets and related terms are similar in nature.

Data Management

Entities may have numerous lease agreements at multiple decentralized locations and may, in many instances, maintain their lease data in spreadsheets or physical documents. Consequently, collecting and abstracting the data may be time-consuming and resource-intensive. Further, even if entities already have such information in an electronic format, it may reside in disparate systems or need to be enhanced to ensure that it complies with ASU 2016-02's accounting and disclosure requirements.

In addition, entities may need to gather information required by the ASU that may not be contained in lease agreements. For example, entities may need to acquire information about (1) the fair value of an asset, (2) the asset's estimated useful life, (3) the incremental borrowing rate, and (4) certain judgments related to lease options. Acquiring this data may be particularly challenging for multinational entities whose lease documentation may be prepared in a foreign language and could also vary as a result of local business practices.

As entities identify and collect the data they need for compliance with the ASU's requirements, they should also consider the challenges of ongoing data maintenance. Data gathering and abstraction efforts may take many months to complete, during which time new leases will be executed, renewed, modified, or terminated. Accordingly, management will need to establish an approach to data maintenance and controls during the implementation period and beyond.

Given the relationship between lease maturity disclosures under current guidance and lease liabilities that will be recognized upon adoption of the ASU (and will be subject to modified retrospective transition, which will affect 2017 financial reporting), we believe that in preparing their December 31, 2016, financial statements, entities should strive to ensure that they have identified a complete population of leases.

Information Technology Systems

As a result of implementing the ASU's requirements, entities will most likely need to enhance their existing information technology systems. The extent of such enhancements will be based on the size and complexity of an entity's lease portfolio and its existing leasing systems. As with any change to existing systems, an entity will need to consider the business ramifications (i.e., the potential impact on existing processes, systems, and controls) and the requirements of system users (e.g., the entity's legal, tax, financial planning and analysis, real estate, treasury, and financial reporting functions).

Also, management may need to consider system changes that will enable the entity to estimate, before adoption, the ASU's effect on key performance indicators and metrics, tax filings, debt covenants, or other filings. In addition, to the extent that an entity prepares IFRS statutory reports for foreign subsidiaries, its systems will need to distinguish between the ASU and IFRS 16 and be equipped to handle the differences between the two standards.

Internal Controls and Business Process Environment

To a significant extent, current lease data systems are used for operational purposes and thus some aspects of the related internal controls may be outside of the scope of the internal control requirements of the Sarbanes-Oxley Act of 2002. Given the increased relevance of leasing data to the financial statements as a result of the ASU, entities may face additional scrutiny from auditors and regulators regarding the design and effectiveness of associated controls. Accordingly, entities will need to examine their internal controls related to their processes for capturing, calculating, and accounting for their leases. If additional internal controls or processes are needed, entities may also need to issue organizational communications and establish change management and employee training programs.

In addition, during their implementation of the standard, entities may identify opportunities for potential enhancements to their current processes to achieve future operational efficiencies. For example, entities may seek to automate manually intensive processes or consider organizational changes such as a shared services model.

Debt Covenants

Given the requirement to bring most leases on the balance sheet, many entities will reflect additional liabilities in their balance sheets after adopting the ASU. Such entities should determine whether the increased leverage will negatively affect any key metrics or potentially cause debt covenant violations. This may depend in part on how various debt agreements define and limit indebtedness as well as on whether the debt agreements use "frozen GAAP" covenants. The ASU requires entities to present operating lease liabilities outside of traditional debt, which may provide relief to some entities. Nevertheless, we believe that it will be critical for all entities to determine the ASU's potential effects on debt covenants and begin discussions with lenders early if they believe that violations are likely to occur as a result of adopting the ASU.

Income Taxes

A lease's classification for accounting purposes does not affect its classification for tax purposes. An entity will therefore continue to be required to determine the tax classification of a lease under the applicable tax laws. While the classification may be similar for either purpose, the differences in tax and accounting principles and guidance often result in book/tax differences. Thus, once an entity implements the new standard, it will need to establish a process to account for these differences.

The ASU's requirement for entities to reevaluate their leases under the new guidance presents an opportunity for them also to reassess the tax treatment of such leases as well as their data collection and processes. Since the IRS considers a taxpayer's tax treatment of leases to be a method of accounting, any changes to existing methods may require IRS consent.

Entities should also consider the potential state tax issues that may arise as a result of the new guidance, including how the classification of the ROU asset may affect the apportionment formula in the determination of state taxable income and how the significant increase in recorded lease assets could affect the determination of franchise tax payable.

Editor's Note: Since the potential tax implications are many and varied, it is essential for a company's tax department to be involved in the evaluation of the lease standard as well as in discussions related to policy adoption and system modifications.

Getting Started

Entities should develop a robust plan and establish a cross-functional implementation team to ensure an efficient and timely approach to implementation. In developing such a plan, they should consider doing the following:

- Performing a current-state assessment of their lease portfolio, including lease volume and types, availability of electronic lease data and data gaps, and any potential challenges related to accounting, taxes, or processes.
- Establishing a project plan for managing the implementation effort for multiple functions, business units, and countries, as necessary.

- Developing an approach to, and resources to perform, the abstraction of lease data.
- Determining their specific system requirements and developing a plan for enhancing system capabilities to satisfy the new storage, calculation, and reporting requirements while keeping in mind the associated internal control implications.
- Assessing the effect of the ASU on their key metrics and debt covenants.

By planning properly, entities can help ensure that their transition to the new leases standard is smooth and successful.

Subscriptions

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No. 2015-09
29 July 2015

Technical Line

FASB — final guidance

Applying the new revenue recognition standard to sales of real estate

In this issue:

What you need to know

- Entities will apply the new revenue recognition standard to revenues from sales of real estate to customers.
- When it issued the new standard, the FASB amended other parts of the ASC to address the accounting for the sale of certain nonfinancial assets, including real estate, to noncustomers.
- Entities will need to apply the recognition and measurement principles in the new standard (including estimating variable consideration) to account for gains or losses resulting from the sale of real estate to noncustomers.
- Entities that sell real estate will generally recognize a gain or loss when they transfer control of a property. They will no longer have to apply the prescriptive real estate sales criteria, including evaluation of the buyer's initial and continuing investments and the seller's continuing involvement with the property.

Overview

As part of Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*, the Financial Accounting Standards Board (FASB) issued consequential amendments to other sections of the Accounting Standards Codification (ASC or Codification) that will require entities to change how they account for sales of real estate. These amendments include the elimination of existing guidance in ASC 360-20, *Real Estate Sales*, and the addition of ASC 610-20, *Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets*.

Building a better working world

Revenues from sales of real estate to customers (i.e., sales that are part of the seller's ordinary activities) will be recognized using the guidance in ASC 606, *Revenue from Contracts with Customers*. However, entities that sell real estate assets to noncustomers[1] will generally account for these transactions using the guidance in ASC 610-20, which directs entities to apply certain control and measurement principles of ASC 606. These new standards will only be applied by sellers of real estate; purchasers will continue to use existing guidance (e.g., ASC 360-10, *Property, Plant, and Equipment* or ASC 805, *Business Combinations)*.

The elimination of today's guidance for sales of real estate in ASC 360-20 will be a major change for all real estate entities. ASC 360-20 is a complex, rules-based standard that requires entities to evaluate both the form and economic substance of a transaction. For some transactions, the application of ASC 360-20 results in the deferral of sale and/or profit recognition when certain criteria are not met.

The new guidance in ASC 606 and ASC 610-20 replaces the prescriptive literature in ASC 360-20 with a principles-based approach that will require entities to make a number of judgments and estimates. Under the new guidance, entities will generally recognize the sale, and any associated gain or loss, of a real estate property when control of the property transfers.

This publication discusses the implications of applying the recognition and measurement principles of ASC 606 and ASC 610-20 to sales of real estate. Throughout this publication, we compare the accounting for several common real estate sale transactions under the new guidance with the accounting under today's guidance in ASC 360-20.

In our discussion and in many of our examples, we use terminology from ASC 360-20 because the new standard does not describe specific real estate sales transactions. Our use of these terms is intended to help you compare the new guidance with today's guidance. By using these terms, we are not suggesting that entities should continue to use the guidance in ASC 360-20 or analogize to it to account for the sale of real estate once the new standard is effective.

In addition, any conclusions we reached in our examples are based on the facts we described and are subject to change. All arrangements will need to be carefully evaluated under the new guidance, based on the facts and circumstances.

This publication supplements our general Technical Line publication on the new standard and the other real estate industry Technical Line publications we have released. It should be read in conjunction with the following materials:

- *A closer look at the new revenue recognition standard* (SCORE No. BB2771)
- *The new revenue recognition standard — real estate* (SCORE No. BB2811)
- *Gains and losses from the derecognition of nonfinancial assets* (SCORE No. BB3021)

Summary of the new guidance

The new guidance in ASC 606 and ASC 610-20 outlines the principles an entity must apply to measure and recognize revenue and the related cash flows. The core principle is that an entity will recognize revenue at an amount that reflects the consideration it expects to be entitled to in exchange for transferring goods or services to a customer.

The prescriptive guidance in ASC 360-20 for evaluating a buyer's initial and continuing investment has been replaced with a collectibility assessment in ASC 606.

The new revenue standard (ASC 606) will be applied using the following five-step model:

Step 1: Identify the contract(s) with a customer

An entity must first identify the contract, or contracts, to provide goods and services to customers. These contracts may be written, oral or implied by the entity's customary business practice but must be legally enforceable and meet specified criteria. That is, the contract must be approved by all parties, and they must be committed to performing their respective obligations, the entity must be able to identify each party's rights regarding goods and services to be transferred and the associated payment terms, the contract must have commercial substance, and the entity needs to conclude it is probable that it will collect the consideration to which it will be entitled for transferring the goods or services to the customer.

Entities will need to consider the laws of their respective jurisdictions (e.g., United States Uniform Commercial Code, state and local real property laws) when determining whether a contract is legally enforceable. In the US, in nearly all real estate arrangements, a signed, written contract specifies the asset to be transferred or management services to be provided in exchange for a defined payment. This generally will result in a straightforward assessment of most of the contract criteria in the standard. The assessment may be different when evaluating transactions that occur in countries outside of the US.

However, the collectibility criterion may require careful consideration. When assessing collectibility, an entity must conclude that it is probable that it will collect the transaction price. The transaction price is the amount to which the entity expects to be entitled in exchange for the goods or services that will be transferred to the customer, which may be different from the stated contract price.

The transaction price may be less than the stated contract price if an entity concludes that it has offered or is willing to accept a price concession or other discount. Such concessions or discounts are forms of variable consideration (see Step 3: Determine the transaction price section below for further discussion) that an entity would estimate at contract inception and reduce from the contract price to derive the transaction price. The estimated transaction price would then be evaluated for collectibility. The following table illustrates these concepts:

Stated contract price	$ 2,000,000
Price concession - amount entity estimates it will offer (explicitly) or accept (implicitly) as a reduction to the contract price, unrelated to credit risk	($200,000)
Transaction price (assessed for collectibility)	$ 1,800,000

In assessing collectibility, the term "probable" is defined as when "the future event or events are likely to occur." This is consistent with the existing definition in US GAAP. An entity should consider the buyer's intent and ability to pay the amount of consideration when it is due in evaluating whether collectibility of the transaction price is probable.

In many circumstances, an entity may not be willing to accept less than the contract price (i.e., offer a price concession) but is willing to accept the risk of default by the customer of contractually agreed-upon consideration (i.e., credit risk). In these circumstances, the transaction price would not differ from the contract price, and this amount would be evaluated to determine if collection is probable.

How we see it

Entities that sell real estate and provide financing to the buyer may find that more judgment is required to evaluate the collectibility of the transaction price. These entities may be used to applying the strict quantitative criteria in ASC 360-20 for determining whether a buyer's initial and continuing investment is sufficient to allow for sale and profit recognition. This guidance will be eliminated, and there is little guidance in the new standard to help entities evaluate collectibility.[2] Therefore, this assessment may be difficult and necessitate that entities develop new processes and controls to evaluate some arrangements, including those in which the seller provides financing to the buyer.

When seller financing is provided, we believe that entities will need to consider a variety of factors when evaluating collectibility of the transaction price. Those factors may include analysis of commercially available lending terms for similar transactions, down payment sufficiency, projected cash flows of the property, borrower creditworthiness, experience and expertise of the buyer's management team and historical experience of the seller in similar transactions.

Step 2: Identify the performance obligations in the contract

The new revenue standard requires an entity to identify at contract inception all promised goods and services and determine which of these promised goods or services (or bundle of goods and services) represent performance obligations. Promised goods and services represent a performance obligation if (1) the goods or services are distinct (by themselves or as part of a bundle of goods and services) or (2) if the goods or services are part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer. A promised good or service that is not distinct is combined with other goods or services until a distinct bundle is formed.

A good or service (or bundle of goods and services) is distinct when both of the following criteria are met:

- The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (i.e., the good or service is capable of being distinct).
- The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., the good or service is distinct within the context of the contract).

Goods or services that are part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer are required to be combined into one performance obligation. To meet the same pattern of transfer criterion, each distinct good or service in the series must be considered a performance obligation satisfied over time (discussed in Step 5), and an entity must use the same method to measure the progress of transferring each distinct good or service (e.g., time elapsed). Examples include repetitive services provided on an hourly or daily basis.

Step 3: Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to the customer and includes:

- An estimate of any variable consideration (e.g., amounts that vary due to discounts or bonuses) using either a probability-weighted expected value or the most likely amount, whichever better predicts the amount of consideration to which the entity will be entitled

- The effect of the time value of money, if there is a financing component that is significant to the contract
- The fair value of any noncash consideration
- The effect of any consideration payable to the customer, such as vouchers and coupons

The transaction price may be constrained because of variable consideration. That is, the standard limits the amount of variable consideration an entity can include in the transaction price to the amount for which it is probable that a significant revenue reversal will not occur when the related uncertainties are resolved. A significant reversal occurs when a change in the estimate results in a significant downward adjustment in the amount of cumulative revenue recognized from the contract with the customer. The transaction price is not adjusted for credit risk.

Step 4: Allocate the transaction price to performance obligations in a contract

An entity must allocate the transaction price to each performance obligation on a relative standalone selling price basis, with limited exceptions. One exception in the standard requires an entity to allocate a variable amount of consideration, together with any subsequent changes in that variable consideration, to one or more performance obligations or one or more (but not all) distinct goods or services promised in a series of goods or services that forms part of a single performance obligation, if specified criteria are met (i.e., terms of the variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service and the allocation of variable consideration is consistent with the objective of allocating the transaction price in an amount the entity expects to be entitled in exchange for transferring the promised goods or services to the customer).

When determining standalone selling prices, an entity must use observable information, if it is available. If standalone selling prices are not directly observable, an entity will need to use estimates based on reasonably available information. Example estimation approaches include an adjusted market assessment approach or an expected cost plus a margin approach.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

Under the new revenue standard, an entity has to determine at contract inception whether it will transfer control of a promised good or service over time. An entity transfers control of a good or service over time (rather than at a point in time) when any of the following criteria are met:

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- The entity's performance creates or enhances an asset (e.g., work in process) that the customer controls as the asset is created or enhanced.
- The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

Customer simultaneously receives and consumes benefits as the entity performs

In developing their new revenue standards, the FASB and International Accounting Standards Board (IASB, together the Boards) intended for this criterion to address repetitive service contracts (e.g., cleaning services, transaction processing), therefore it is unlikely to be applied when a real estate asset is sold.

However, this criterion may be applicable to a management contract that is retained by the seller of a real estate property. Real estate entities that provide property management and other services will need to carefully evaluate their contracts to determine whether the services performed are simultaneously received and consumed by the customer (i.e., real estate owner). For further discussion of these and other topics affecting the real estate industry, refer to our Technical Line publication, *The new revenue recognition standard — real estate*.

Customer controls asset as it is created or enhanced

The Boards said[3] they believe the customer's control over the asset as it is being created or enhanced indicates that the entity's performance transfers goods or services to a customer over time. For example, in a construction contract in which an entity is building an asset on the customer's land, the customer generally controls any work in process resulting from the entity's performance.

For discussion of the application of this criterion to construction contracts, refer to our Technical Line publication, *The new revenue recognition standard — engineering and construction*.

Asset with no alternative use and right to payment

The Boards acknowledged[4] that the application of the first two criteria could be challenging in certain circumstances. For example, a developer may construct an asset but transfer title of the land and/or building to the customer only upon completion. As a result, a third criterion was added that, if both of the following requirements are met, will require entities to recognize revenue for a performance obligation over time:

- The entity's performance does not create an asset with alternative use to the entity.
- The entity has an enforceable right to payment for performance completed to date.

For further discussion of this criterion and its application to sales of real estate, refer to the section "Sales of real estate by real estate developers" below.

Control transferred at a point in time

Control is transferred at a point in time if none of the criteria for a good or service to be transferred over time is met. For sales of existing real estate properties, transfer of control will generally occur at a point in time.

The Boards included five indicators in ASC 606 for entities to consider when determining whether control of a promised asset has been transferred at a point in time. These indicators include consideration of whether the seller has a present right to payment for the property and whether title to, and physical possession of, the property has been transferred to the buyer.

Scope

ASC 606 applies to all contracts with customers (i.e., parties that have contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities), except for contracts that are specifically excluded from the scope, which include:

- Lease contracts within the scope of ASC 840, *Leases*
- Financial instruments and other contractual rights or obligations (e.g., receivables, debt and equity securities, derivatives)[5]
- Guarantees (other than product or service warranties) within the scope of ASC 460, *Guarantees*

- Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange within the scope of ASC 845, *Nonmonetary Transactions*

Entities may enter into transactions that are partially within the scope of the new revenue guidance and partially within the scope of other guidance. In these situations, the new guidance requires an entity to first apply any separation and/or measurement principles in the other guidance before applying the revenue standard.

For example, in certain transactions, the seller of a real estate property may agree to support the operations of the property for a period of time or provide a guarantee of the buyer's return on investment. Under today's guidance, because these guarantees either prevent the guarantor from being able to account for the transaction as a sale or recognize in earnings the profit from the sale, these "seller support" guarantees are excluded from the scope of ASC 460 and are instead accounted for using ASC 360-20.

Under the new standard, the presence of a guarantee does not, on its own, affect whether an entity can recognize a sale and the associated profit from the transfer of the property. Instead, the fair value of the guarantee will first be separated from the transaction price and recorded as a liability in accordance with ASC 460.[6] The remainder of the estimated arrangement consideration is allocated among the other elements in the arrangement (e.g., other performance obligations, including the transfer of the asset). The entity then evaluates whether the other performance obligations have been satisfied without considering the guarantee.

Sales of nonfinancial assets

The sale of real estate (i.e., a nonfinancial asset or in substance nonfinancial asset) could be within the scope of ASC 606, if the sale is to a customer, or ASC 610-20, if the sale is to a noncustomer. The new revenue guidance defines a customer as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." The standard does not define the term "ordinary activities" because it was derived from existing guidance. CON 6[7] refers to ordinary activities as an entity's "ongoing major or central operations."

Nonfinancial assets, including real estate properties, are often sold in transactions that would not represent a contract with a customer because the sale of the asset is not an output of the entity's ordinary activities (e.g., the sale by an entity of its corporate headquarters building). If an entity sells a nonfinancial asset to a party that is a customer in other transactions (i.e., the party is purchasing goods or services from the entity that are the output of the entity's ordinary activities), the purchasing party will be considered a customer for the transactions involving the goods or services but not for the sale of the nonfinancial asset.

The FASB amended ASC 360-10 to help entities apply the appropriate guidance when derecognizing a nonfinancial asset (e.g., real estate) sold to a noncustomer. The amended guidance states that sales of nonfinancial assets, including in substance nonfinancial assets, should be accounted for using new guidance in ASC 610-20, unless the contract is with a customer. However, ASC 610-20 does not contain incremental guidance to ASC 606 but rather instructs entities to apply certain control and measurement guidance from ASC 606, including guidance related to:

- Evaluating the existence of a contract
- Measuring the consideration (i.e., determining the transaction price) in the contract
- Determining when control of the nonfinancial asset has transferred (i.e., when a performance obligation is satisfied)

Accounting for contracts that include the sale of a nonfinancial asset to a noncustomer or a customer generally will be consistent, except for financial statement presentation and disclosure. The Boards noted in the Basis for Conclusions[8] in the new standard that there is economically little difference between the sale of real estate that is, or is not, an output of the entity's ordinary activities and that the only difference in the accounting for these transactions should be the presentation in the statement of comprehensive income (i.e., revenue and expense when the sale is to a customer or gain or loss when the sale is to a noncustomer). Entities that sell nonfinancial assets to noncustomers will follow guidance in ASC 360-10 for presenting a gain or loss on the sale of a long-lived asset.

In certain circumstances, neither ASC 606 nor ASC 610-20 will be applied when derecognizing a nonfinancial asset. Instead, the sale of nonfinancial assets in a subsidiary or group of assets that meets all of the following requirements will be accounted for in accordance with the derecognition guidance in ASC 810, *Consolidation*:[9]

- The nonfinancial assets are not being sold to a customer (i.e., they are not outputs of the entity's ordinary activities).
- The nonfinancial assets in a subsidiary or group of assets meet the definition of a business.
- The nonfinancial assets in a subsidiary or group of assets are not in substance nonfinancial assets (e.g., because the group of assets or subsidiary also contains significant financial assets).
- No other scope exceptions in ASC 810-10 apply.

The following table summarizes the appropriate derecognition guidance to apply to common transactions involving real estate:

ASC topic	When applied?	Possible transactions
ASC 606, *Revenue from Contracts with Customers*	Sales to customers of real estate (i.e., nonfinancial assets or in substance nonfinancial assets, regardless of whether they also meet the definition of a "business")	Sales of residences by homebuilders and real estate developers
ASC 610-20, *Other Income - Gains and Losses from the Derecognition of Nonfinancial Assets*	Sales to noncustomers of real estate (i.e., nonfinancial assets or in substance nonfinancial assets, regardless of whether they also meet the definition of a "business")	Sales of commercial properties (e.g., office buildings, hotels, manufacturing facilities) by REITs, real estate funds with historical cost reporting and non-real estate entities
ASC 810-10, *Consolidation - Overall*	Sale (deconsolidation) to noncustomers of real estate in a subsidiary or group of assets that constitutes a "business" that is not, in substance, a nonfinancial asset (e.g., group of assets comprised of both financial and nonfinancial assets)	Sales by any entity of an asset group including real estate that together are a "business" and are not considered in substance nonfinancial assets

How we see it

The FASB did not define an "in substance nonfinancial asset" in the consequential amendments. An entity that derecognizes a subsidiary or group of assets that meet the definition of a business will need to exercise significant judgment to determine whether the transaction also constitutes the transfer of an in substance nonfinancial asset that will be subject to the guidance in ASC 610-20 rather than ASC 810-10.

The FASB has a project[10] on its agenda to clarify the definition of a business. In subsequent phases of this project, the FASB also plans to clarify the accounting for the acquisition or disposal of in substance nonfinancial assets and provide guidance for partial sales. It's not clear whether or when the FASB will issue additional guidance.

Sales of real estate that qualify for full accrual profit recognition under ASC 360-20 will generally continue to meet the criteria for sale and associated profit recognition under the new guidance.

Sale and leaseback transactions

While the FASB made it clear that ASC 360-20 should no longer be applied to sales and transfers of real estate, the guidance was retained on sale and leaseback transactions involving real estate that are within the scope of ASC 840-40, *Sale-Leaseback Transactions*. ASU 2014-09 included a number of consequential amendments that narrowed the scope of ASC 360-20, and the FASB stated[11] that entities should not analogize to the retained guidance when evaluating any transaction that is not a sale-leaseback.

The FASB plans to issue new guidance on leases later this year, including new guidance for sale-leaseback transactions that will eventually replace the guidance in ASC 360-20 and ASC 840-40. Under the proposal, a seller-lessee would use the definition of a sale in ASC 606 to determine whether a sale has occurred in a sale and leaseback transaction (e.g., whether the buyer-lessor has gained control of the underlying asset). In addition, the new leases standard would eliminate existing guidance for sale and leaseback transactions specifically involving real estate. For further information about the forthcoming leases standard, refer to our Technical Line publication, *Final standard on leases is taking shape* (SCORE No. BB2952).

Nonmonetary transactions

The new revenue standard provides guidance for contracts with customers involving the exchange of nonmonetary consideration. As a result, the FASB excluded contracts that fall within the guidance of ASC 606 and ASC 610-20 from the scope of ASC 845. However, the FASB clarified that the exchange of a nonfinancial asset (including an in substance nonfinancial asset) for a noncontrolling ownership interest in the receiving entity will remain within the scope of ASC 845. In addition, the specific guidance in ASC 845 for exchanges of real estate involving monetary consideration will be eliminated.

Sales previously recognized using the full accrual method

ASC 360-20 provides the general principles that full profit on a real estate sale can be recognized if the profit is determinable and the earnings process is virtually complete. ASC 360-20 includes a number of criteria that describe how to determine whether these general principles are satisfied and the appropriate accounting to apply in circumstances in which the criteria are not met. These criteria in ASC 360-20 generally require an assessment of whether:

- The sale has been consummated.
- The buyer's initial and continuing investments demonstrate a commitment to pay for the property.
- The seller's receivable is not subject to future subordination.

- The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property sold.

Recognition of the full profit when these criteria are satisfied is referred to as the "full accrual method." Many sales of real estate meet the criteria for full accrual profit recognition at the date of sale. For example, the criteria for full accrual recognition are generally satisfied if, upon the closing of a transaction, the buyer pays the full purchase price in cash, obtains title and possession of the property (including the risks and rewards of ownership), and the seller has no further involvement or obligation associated with the property. Even if the full purchase price is not paid in cash (e.g., the sale includes some form of non-subordinated seller financing) or the seller retains a non-prohibited form of continuing involvement, the full accrual criteria could be met if the sale has been consummated and the buyer's initial and continuing investments are sufficient.

It is likely that the timing of sale (and associated profit) recognition for transactions that qualify for full accrual profit recognition under ASC 360-20 will be consistent with the timing of sale (and associated profit) recognition for the same transactions under the new guidance. The new guidance provides that sales of nonfinancial assets (e.g., real estate) will be recognized when control of the asset transfers to the buyer, which will occur when the buyer has the ability to direct the use of, or obtain substantially all of the remaining benefits from, the asset. This will generally occur at the closing of the transaction. The following illustration compares full accrual profit recognition under ASC 360-20 to revenue/gain recognition under ASC 606/610-20.

Illustration 1: Sale recognized using full accrual method in ASC 360-20

An office building is sold for $1 million, and Seller A receives $1 million in cash ($150,000 directly from the buyer and $850,000 of proceeds from a secured first mortgage the buyer entered into with a third-party lender). Seller A is not contingently liable for the mortgage nor does it have any other risks related to the buyer's financing. Seller A transferred title and physical possession of the property to the buyer on the closing date of the transaction and has no continuing involvement with the property.

Future GAAP analysis (ASC 606/610-20):

Seller A determines that control of the building transfers at a point in time (rather than over time) and considers the indicators of control transfer, as well as any other relevant information. Seller A determines that the criteria to recognize revenue (i.e., gain on sale) have been met at closing because title and physical possession of the property were transferred to the buyer, and the contract specifies Seller A's right to payment (which has already been received in this transaction).

Current GAAP analysis (ASC 360-20):

Seller A received the full sales value of the property in cash, without any contingent liability on the debt incurred by the buyer or any other risk related to the buyer's financing. Therefore, the initial and continuing investment requirements are not applicable, and full profit recognition is appropriate assuming all other criteria for recognizing profit under the full accrual method (e.g., Seller A has no prohibited forms of continuing involvement) were satisfied.

Recognition when control of the property has not transferred

If an entity evaluates the indicators described above and concludes that control of the property has not transferred under ASC 606 or ASC 610-20, as applicable, a sale has not occurred and the asset is not derecognized. The entity records any consideration received as a contract liability (e.g., deposit liability), not as revenue/gain, until it concludes that the buyer has obtained control of the property. This accounting will be similar to the "deposit method" in today's guidance, which is applied when there is no consummation of a sale.

Sales for which initial or continuing investment criteria in ASC 360-20 are not met

Under ASC 360-20, collectibility of the sales price is demonstrated by the buyer's commitment to pay for the property. ASC 360-20 includes detailed guidance on evaluating whether the composition and size of the buyer's initial and continuing investments are adequate to demonstrate the buyer's commitment to pay for the property. When the initial or continuing investment tests are not met, the seller is required to defer profit at the sale date and recognize it in later periods using one of the alternative methods provided in ASC 360-20. In certain cases, a seller may determine that the buyer's investment is insufficient to recognize a sale and may instead apply the deposit method.

The new guidance eliminates all of the prescriptive requirements in ASC 360-20 for evaluating the buyer's initial and continuing investment and introduces new judgments that must be made regarding collectibility. The removal of the initial and continuing investment criteria may result in immediate recognition (i.e., gain on sale) for transactions for which gain deferral has been required under ASC 360-20.

Under the new guidance, however, a seller will still have to evaluate, at contract inception, whether it is probable that it will collect the consideration to which it expects to be entitled. The standard also says that entities should assess both the customer's intent and ability (i.e., capacity) to pay the amount to which the entity will be entitled. In some circumstances, the amount of consideration to which an entity will be entitled may be less than the price stated in the contract because the entity might provide a price concession to the customer. Such concessions or discounts are forms of variable consideration that an entity would estimate at contract inception and deduct from the contract price to determine the transaction price. Significant judgment will be required to determine whether an entity's expectation that it will receive less than the stated contract price indicates that the contract amount is not probable of collection or represents a price concession. Refer above to "Summary of the new guidance" section for further discussion of price concessions.

If it is not probable that the entity will collect the transaction price, the arrangement would not be considered a contract under the new guidance until the concerns about collectibility are resolved (i.e., becomes probable the transaction price will be collected). If the entity subsequently determines that the transaction price is probable of collection, the arrangement will then be recognized under the new guidance. Entities will apply similar judgments to those at contract inception (e.g., all parties have approved the contract, payment terms have been identified) when subsequently determining that the transaction price is probable of collection.

The new guidance addresses situations in which an arrangement does not meet the contract criteria (e.g., an entity determines that it is not probable that it will collect the transaction price). In certain circumstances, an entity may receive consideration from a customer (e.g., a down payment) before the contract criteria have been satisfied. When an arrangement doesn't meet the criteria to be accounted for as a contract, any consideration received from the customer is initially accounted for as a liability (not revenue/gain on sale), and assets transferred to the customer are not derecognized. This accounting is required even if the "deposit" exceeds the seller's carrying value of the property (unless one of the criteria noted below is met). The liability is measured at the amount of consideration received from the customer. This approach is similar to the deposit method prescribed in ASC 360-20.

An entity may only recognize consideration received as revenue/gain on sale when it subsequently determines that the agreement meets the criteria of a contract under the new guidance or when either of the following occurs:

- The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable.
- The contract has been terminated, and the consideration received from the customer is nonrefundable.

The following illustrates a transaction accounted for under the new standard for which the seller determines at sale closing that the transaction price is not collectible (Illustration 2). Based on changes in the borrower's ability to pay, the seller determines that collectibility is probable in a later period (Illustration 3). In addition, Illustration 2 reflects considerations for determining whether a contract is in the scope of ASC 606 or ASC 610-20.

Illustration 2: Seller financing with collectibility concerns at sale closing

Seller R owns and leases commercial real estate and, on occasion, will dispose of a property that no longer fits its operating or capital strategy. Seller R decides to sell an office building with a carrying value of $800,000 through the sale of its interest in a wholly owned subsidiary. The office building is the sole asset of the subsidiary. Seller R agrees to sell its 100% interest in the legal entity to another real estate operator, Buyer W, for $1,000,000, consisting of $50,000 of cash (paid up front and nonrefundable) and a 10-year nonrecourse first mortgage from Buyer W for $950,000. Substantially all of the office building is leased at acquisition.

Because the seller provided nonrecourse financing, cash flows from operation of the property will be primarily relied upon to service the mortgage. The leases of the largest two tenants in the building expire within the next two years and there is significant uncertainty regarding Buyer W's ability to replace them with new tenants willing to pay comparable rents; therefore, there is uncertainty whether the property will continue to generate the cash flows necessary to service the mortgage. However, Seller R has attempted to dispose of this office building for several years and is willing to accept the risk of this contract since it has the ability to repossess the property, if necessary.

The terms of the contract include required principal payments of $100,000 per year beginning in the second year of the contract, a $150,000 balloon payment at the end of the contract, and interest at a rate of 12% (which reflects the current market conditions and credit characteristics of Buyer W). For purposes of this example, we have ignored the accounting for the interest component.

Analysis: Seller R determines that the transaction is not with a customer because the sale is not part of Seller R's normal business activities of operating and leasing commercial real estate. Therefore, the transaction is outside the scope of ASC 606.

Seller R determines that it should apply ASC 610-20 because it has sold an in substance nonfinancial asset to a noncustomer (i.e., it transferred to Buyer W its 100% interest in a legal entity that held substantially only nonfinancial assets (i.e., an office building)). While the presence of in-place leases would likely have resulted in a conclusion by Seller R that the building was also a business, ASC 610-20 is applied to all sales of in substance nonfinancial assets, regardless of whether the asset sold also constitutes a business.

As a result of the uncertainty about whether the property will generate the cash flow necessary to service the mortgage, Seller R determines at contract inception that collection of the transaction price is not probable. Therefore, the remaining applicable aspects of ASC 606 (i.e., the measurement and derecognition principles) cannot be applied to the arrangement until Seller R is able to conclude that collectibility of the transaction price is probable. Seller R must account for the receipt of the $50,000 non-refundable down payment as a liability and does not derecognize the office building or record a mortgage receivable. Seller R also continues to recognize depreciation of the asset (assumed to be $25,000 per year for purposes of the example).

Dr. Cash	$	50,000		
Cr. Deposit liability			$	50,000
Dr. Depreciation expense	$	25,000		
Cr. Accumulated depreciation			$	25,000

Illustration 3: Subsequent evaluation of collectibility

Following Illustration 2, Seller R continues to assess the contract to determine whether the transaction price is probable of collection. In the second year of the arrangement, Seller R receives a principal payment of $100,000 but continues to believe that collectibility of the remaining balance is not probable because Buyer W has yet to execute new leases for the space that will become available in the near term. As a result, Seller R records the $100,000 payment received as a deposit liability and continues to recognize depreciation of the asset. For purposes of this example, we have again ignored the accounting for the interest component.

In the third year of the arrangement, Seller R receives a $100,000 principal payment and Buyer W has recently entered into new long-term leases with the two largest tenants in the office building.

Analysis: Based on the change in Buyer W's circumstances, in Year 3, Seller R determines that Buyer W has the intent and ability to pay the full amount due and that it is now probable that it will collect the unpaid portion of the transaction price (i.e., the outstanding mortgage receivable). Seller R also determines that control transferred at a point in time (e.g., title to the asset previously transferred when the ownership of the entity owning the real estate was transferred and the buyer has physical possession). Seller R therefore derecognizes the property and recognizes gain on sale and a mortgage receivable for cash consideration that remains outstanding.

Dr. Cash	$	100,000		
Dr. Mortgage receivable	$	750,000		
Dr. Deposit liability	$	150,000		
Cr. Building, net			$	750,000
Cr. Gain on Sale			$	250,000

Note: The mortgage receivable of $750,000 is calculated by subtracting cash payments received from the total selling price ($1,000,000 less the down payment of $50,000 and two subsequent payments of $100,000 each). The gain on sale of $250,000 is calculated by subtracting the carrying value of the asset transferred from the total sales price ($1,000,000 less carrying amount of $750,000, which is comprised of the initial carrying value of $800,000 net of two years of depreciation of $25,000 each).

Accounting under current GAAP (ASC 360-20)

The transaction in these illustrations would not have initially met the initial investment criteria in ASC 360-20. Assuming the sale was consummated, the down payment was not in substance an option, recovery of the cost of the property was reasonably assured and the seller retained no form of prohibited continuing involvement, a sale would have been recognized on the closing date. However, profit would have been recognized using the installment or cost recovery method until the initial and continuing investment criteria were satisfied.

Sales with forms of continuing involvement

Under ASC 360-20, a seller generally cannot recognize profit on the sale of real estate under the full accrual method if it retains continuing involvement in the property without transferring substantially all of the risks and rewards of ownership. ASC 360-20 provides detailed guidance on how to consider the various forms of continuing involvement a seller may have with a property after it has been sold and requires the use of alternative accounting methods (e.g., financing, leasing, performance-of-services, profit-sharing methods) in certain circumstances, based on the nature and extent of the continuing involvement.

The concept of continuing involvement is not a specific consideration in the new guidance. Under the new guidance, a seller focuses on the transfer of control of the property to determine when the performance obligation is satisfied and associated revenue (i.e., gain on sale) or loss is recognized. In addition, an entity will assess whether any aspects of a contract (including those that result in continuing involvement under today's guidance) either represent a separate performance obligation or affect whether control of the real estate has transferred to the buyer. However, activities that were considered continuing involvement under ASC 360-20 may affect whether control transfers or whether an additional distinct promised good or service is present other than the sale of real estate.

Unlike today's guidance, future consideration from a real estate sale may be recognized when control of the property transfers.

The following sections describe a few of the common forms of continuing involvement under ASC 360-20 and compare today's accounting for these transactions to the accounting under the new model in ASC 606 and ASC 610-20.

Seller participates in future profit

In some real estate sales arrangements, the seller participates in future profits (e.g., from the property's operating profits or residual values) without further obligation or risk of loss, in addition to receiving fixed consideration from the sale of the property.

Under today's guidance, a seller may recognize profit from the fixed consideration if all other criteria for full accrual profit recognition in ASC 360-20 have been met. However, any future profit participation is recognized only when those amounts are realized.

Under the new guidance, amounts from future profit participation will represent variable consideration that a seller will need to estimate at contract inception and include in the transaction price when it is "probable" that a significant revenue reversal will not occur when the uncertainties related to the variability are resolved. An entity is required to estimate variable consideration using either the "expected value" approach (i.e., the sum of probability-weighted amounts) or the "most likely amount" approach (i.e., the single most likely outcome), whichever better predicts the amount of consideration to which it will be entitled. That is, the method selected is not meant to be a "free choice." The entity should apply the selected method consistently throughout the contract and update the estimated transaction price at each reporting date.

The Boards indicated[12] that the "most likely amount" approach may be the better predictor when the entity expects to be entitled to only one of two possible amounts (e.g., a contract in which an entity is entitled to receive all or none of a specified performance bonus but not a portion of that bonus). The following provides an illustration of how a real estate entity would estimate variable consideration resulting from future profit participation from a sale of real estate under the new standard.

Illustration 4: Estimating variable consideration

Developer D sells a newly constructed commercial property with a cost basis of $1.9 million for $2.0 million, plus a right to receive 5% of future operating profit from the property for the first year. Developer D has no additional ongoing performance obligations. Developer D determines there are a number of possible outcomes of consideration to be received based on the performance of the property (e.g., the buyer's ability to effectively secure tenants for the entire property at favorable rental rates). The buyer currently has executed leases or letters of intent from prospective tenants for 50% of the property.

Analysis: Developer D determines that the "expected value" approach is the better predictor of the variable consideration since multiple outcomes are possible.

Based on the buyer's current pre-leasing, Developer D estimates the following future profit participation:

Future profit	**Probability**
$ 50,000	10%
$ 25,000	70%
$ 0	20%

Assume for purposes of this illustration that the constraint, discussed further below, does not limit the amount that can be included in the transaction price at contract inception (i.e., assume it is probable that a significant revenue reversal will not occur). Using a probability-weighted estimate, Developer D would include $22,500 [($50,000 x 10%) + ($25,000 x 70%) + ($0 x 20%)] in the transaction price associated with this variable consideration. That is, the transaction price would be $2,022,500.

Developer D updates its estimate of the transaction price at the next reporting date, and after considering that the buyer now has letters of intent or executed leases for 75% of the property, determines it is now 75% likely to receive future profit participation of $50,000 and 25% likely to receive $25,000. As a result, Developer D's estimate of variable consideration is updated to $43,750 [($50,000 x 75%) + ($25,000 x 25%)] and additional revenue (i.e., gain on sale) of $21,250 ($2,043,750 − $2,022,500) is recognized.

To include variable consideration in the estimated transaction price, the entity has to first conclude that it is "probable" that a significant revenue reversal will not occur when the uncertainties related to the variability are resolved. For purposes of this analysis, "probable" is defined as "the future event or events are likely to occur," consistent with the existing definition in US GAAP. The Boards provided factors that may indicate that revenue is subject to a significant reversal:

- The amount of consideration is highly susceptible to factors outside the entity's influence (e.g., market volatility, judgment or actions of third parties, weather conditions).
- The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

- The entity's experience (or other evidence) with similar types of contracts is limited or that experience (or other evidence) has limited predictive value.
- The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- The contract has a large number and broad range of possible consideration amounts.

The indicators provided by the Boards are not meant to be an all-inclusive list, and entities may note additional factors that are relevant in their evaluations. In addition, the presence of any one of these indicators does not necessarily mean that it is probable that a change in the estimate of variable consideration will result in a significant revenue reversal.

When an entity is unable to conclude that it is probable that a change in the estimate of variable consideration that *would* result in a significant revenue reversal will not occur, the amount of variable consideration is limited. In addition, when an arrangement includes variable consideration, an entity should update both its estimate of the transaction price and its evaluation of the constraint throughout the term of the contract to depict conditions that exist at each reporting date.

The following provides an illustration of how an entity would apply the constraint in estimating variable consideration under the new standard:

Illustration 5: Evaluating the constraint
Assume the same facts as in Illustration 4 except that the buyer of the property has just begun negotiations with prospective tenants and has not signed lease agreements for a significant amount of space. *Analysis:* Developer D uses the "expected value" approach and estimates it is 25% likely to receive future profit participation of $50,000, 50% likely to receive $25,000 and 25% likely to receive none. Using a probability-weighted estimate (prior to considering the constraint), Developer D would include $25,000 [($50,000 x 25%) + ($25,000 x 50%) + ($0 x 25%)] in the transaction price associated with this variable consideration. That is, the transaction price would be $2,025,000. In this illustration, Developer D concludes that the constraint would be set at $25,000 (i.e., the amount for which it's probable that a significant reversal will not occur), therefore the full $25,000 would be included in the transaction price.

Seller provides management or development services to a buyer

A seller of real estate may agree to provide management services for the buyer for a period of time or commit to develop the property in the future (e.g., construct facilities on the land, provide improvements or amenities, such as roads, sewer lines or parks).

If the real estate property in the transaction is sold to a noncustomer, the sale is within the scope of ASC 610-20, which does not include guidance or refer to ASC 606, for identifying performance obligations and allocating consideration. If providing management or development services would generally be considered part of a real estate entity's ordinary activities, these services would be in the scope of ASC 606. Because the arrangement is partially in the scope of ASC 606 and partially outside, the guidance provided in ASC 606 for identifying performance obligations and allocating consideration will be applied to the entire arrangement since ASC 610-20 does not provide such direction.

To determine the performance obligations in the arrangement, a seller evaluates whether the management or development services are (1) capable of being distinct and (2) distinct within the context of the contract. If an entity concludes that more than one performance obligation is present in the contract, the transaction price is allocated to each based on their relative standalone selling prices. For further discussion, refer to Section 2 and 4 of our Technical Line publication, *The new revenue recognition standard — real estate.*

Development services

ASC 360-20 allows a seller that commits to develop the property sold to recognize profit using the percentage-of-completion method if (1) the seller can reliably estimate the future costs of development and the total profit that will be realized in the arrangement and (2) all other criteria for recognizing profit under the full accrual method have been satisfied.

Under ASC 360-20, if future costs of development can be reasonably estimated (i.e., the transaction would qualify to be accounted for using the percentage-of-completion method) but the transaction is otherwise required to be accounted for using the installment, cost recovery or reduced-profit method because the criteria for using the full accrual method have not been satisfied, both the percentage-of-completion method and the other applicable reduced profit method should be considered in determining the amount of profit to recognize. If a seller cannot reasonably estimate the future costs of development, no profit is recognized until costs can be reliably estimated or development is complete.

Under the new revenue standard, if an entity determines that the property and development services represent separate performance obligations in a contract with a customer, the transaction price is estimated (considering the constraint on any variable consideration) and allocated on a relative basis to each performance obligation based on their standalone selling prices. Revenue is then recognized when (or as) control is transferred. As discussed above, we anticipate that this guidance will also generally be applied when entities enter into these contracts with noncustomers because the transaction is partially in the scope of ASC 606 and partially in the scope of ASC 610-20. The guidance provided in ASC 606 for identifying performance obligations and allocating consideration will be applied to the entire arrangement since ASC 610-20 does not provide such direction.

Illustration 6: Sale of land with development contract

Developer D sells land with a carrying amount of $400,000 to Homebuilder V and agrees to build access roads and develop a recreation facility on the land for total consideration of $1,500,000. The estimated cost to complete the development (i.e., access roads and recreation facility) is $400,000, which is based on Developer D's experience and is considered reliable. Developer D incurs $160,000 in development costs in year 1 and $240,000 in costs in year 2. The standalone selling price of the land is $1,000,000, and the standalone selling price for the development services is $600,000.

Future GAAP analysis (ASC 606/610-20):

The sale of land and corresponding performance of development services are both part of Developer D's ordinary activities, so the entire transaction is within the scope of ASC 606. In contrast, if the sale of land was not part of Developer D's ordinary activities (e.g., if Developer D generally only performed development services and rarely sold raw, undeveloped land), the transaction would be partially in the scope of ASC 610-20 (i.e., sale of land to noncustomer) and partially in the scope of ASC 606 (i.e., performance of development services). In these circumstances where the transaction is partially in the scope of both standards, the guidance in ASC 606 for identifying performance obligations and allocating the transaction price will be applied to the overall arrangement since ASC 610-20 does not include such guidance. The measurement and recognition for the land would be the same under either ASC 606 or ASC 610-20 because ASC 610-20 relies on the concepts of ASC 606.

Developer D evaluates the arrangement and determines that the land and development services are each capable of being distinct and are distinct within the context of the contract, thus representing separate performance obligations under the new revenue standard.

Developer D must allocate the $1,500,000 transaction price based on the relative standalone selling prices of the land and development services. On a relative standalone selling price basis, the land represents 62.5% of the transaction price, or $937,500, and the management services represent 37.5% of the transaction price, or $562,500.

When control of the land transfers, Developer D recognizes revenue (and corresponding profit) based on the amount of the transaction price allocated to the land. The remaining transaction price allocated to the development services is recognized when (or as) control of the improvements is transferred to Homebuilder V.

For example, if Developer D determines that Homebuilder V controls the improvements as they are created, recognition of revenue over time, based on Developer D's selected measure of progress (e.g., cost incurred), may be appropriate. Profit from the total arrangement would be recognized as follows:

Profit recognized at sale closing: $537,500

$937,500 transaction price of land − $400,000 carrying value of land

Profit recognized in Year 1: $65,000

[$562,500 transaction price of development services x ($160,000 costs incurred/$400,000 total development costs)] − $160,000 costs incurred

Profit recognized in Year 2: $97,500

[$562,500 transaction price of development services x ($240,000 costs incurred/$400,000 total development costs)] − $240,000 costs incurred

Current GAAP analysis (ASC 360-20):

If all other criteria for recognizing revenue under the full accrual method in ASC 360-20 have been satisfied, Developer D should account for the arrangement using the percentage-of-completion method as follows:

Projected profit:

Sales value	$ 1,500,000
Costs	
Land	400,000
Development	400,000
	800,000
Total projected profit	$ 700,000

Profit recognized at sale closing: $350,000

($400,000 costs incurred/$800,000 total costs) x $700,000 projected profit

Profit recognized in Year 1: $140,000

($160,000 costs incurred/$800,000 total costs) x $700,000 projected profit

Profit recognized in Year 2: $210,000

($240,000 costs incurred/$800,000 total costs) x $700,000 projected profit

While the total profit recognized in this illustration is the same under either standard, $187,500 of additional profit is recognized at sale closing when the new revenue standard is applied to this transaction.

Management services

Under ASC 360-20, if a seller agrees to provide management services to the buyer of a property, the compensation for those services is excluded from the sales value of the property and recognized separately over the period of the management contract. If the services are provided "free of charge" or at a reduced rate, the seller must impute compensation for the management services (i.e., reduce the sales value of the property by the present value of the market rate of the services).

ASC 606 instead requires the seller to separately estimate the standalone selling prices of the real estate asset and the management services and allocate the transaction price (including any estimates of variable consideration that are not constrained) on a relative basis, assuming the entity determines the contract has two performance obligations. The following illustration compares the potential differences in the recognition of profit for these arrangements under ASC 360-20 and the new standard:

Illustration 7: Sale of land with management contract

Hotel Company M sells a hotel with a carrying value of $1,500,000 for $2,000,000 and agrees to manage the property for three years at no additional cost to Buyer R. The standalone selling price of the hotel is $1,800,000, and the standalone selling price for the management services is $100,000 per year. The current market rate of interest that reflects the credit characteristics of the buyer is 10%.

Future GAAP analysis (ASC 606/610-20):

The sale of a hotel is not part of Hotel Company M's ordinary activities (e.g., Hotel Company M ordinarily operates hotels under management agreements or provides licenses to franchisees and generally does not own and sell hotel properties), so the transaction is partially in the scope of ASC 610-20 (i.e., sale of the hotel to a noncustomer) and partially in the scope of ASC 606 (i.e., performance of management services). In these circumstances, the guidance in ASC 606 for identifying performance obligations and allocating the transaction price will be applied to the overall arrangement since ASC 610-20 does not include such guidance. The measurement and recognition for the hotel would be the same under either ASC 606 or ASC 610-20 because ASC 610-20 relies on the concepts of ASC 606.

Hotel Company M evaluates the arrangement and determines that the hotel and management services are each capable of being distinct and distinct within the context of the contract, thus representing separate performance obligations.

Hotel Company M must allocate the $2,000,000 transaction price based on the relative standalone selling prices of the hotel ($1,800,000) and management services ($100,000 x three years, or $300,000). On a relative basis, the transaction price is allocated as follows: the hotel property 85.7% ($1,800,000/$2,100,000), or $1,714,286, and the management services 14.3% ($300,000/$2,100,000), or $285,714.

Hotel Company M recognizes profit of $214,286 ($1,714,286 – $1,500,000) when control of the property transfers. The $285,714 of transaction price allocated to the management services is recognized over the remaining term of the contract based on Hotel Company M's selected measure of progress (e.g., time elapsed).

Current GAAP analysis (ASC 360-20):

Hotel Company M imputes compensation for the management services to be performed and recognizes that amount over the term of the management contract. The present value of $100,000 per year for three years, discounted at 10%, is $248,695.

If all other criteria for recognizing profit under the full accrual method are satisfied (including the initial and continuing investment tests after reducing the sales value by the consideration imputed for the management services), Hotel Company M recognizes profit of $251,305 ($2,000,000 sales price – $1,500,000 carrying amount – $248,695 discounted management fee) at the time of sale.

While the total profit recognized in this illustration is the same under either standard, $37,029 less is recognized at sale closing when the new standard is applied to this transaction.

Consideration of a significant financing component

Under the new standard, a significant financing component may be present in a contract if the timing of payments explicitly or implicitly provides the customer or the entity (i.e., the seller) with a significant benefit of financing the transfer of goods or services. The standard doesn't provide guidance on evaluating whether a financing component is significant, so entities will have to use judgment when making this determination.

For simplicity, illustrations 6 and 7 don't address the timing of payments in the arrangement (i.e., whether all consideration is paid at closing or a portion is paid as the services are provided). A significant financing component could be in the form of prepayment or a delayed payment. For example, if a contract contains "prepayments" for goods or services that will not be transferred for more than a year, an entity has to evaluate whether the timing of payments indicates that the arrangement contains a significant financing component.

If an entity concludes that the contract contains a significant financing component, the expected consideration is adjusted to reflect the cash selling price of the goods or services. When a contract has more than one performance obligation, such as those illustrated above, entities will need to use judgment when determining whether and how to allocate the financing to each performance obligation. The FASB-IASB Transition Resource Group for Revenue Recognition (TRG) recently discussed this issue and members of the TRG generally agreed that it may be reasonable for entities to apply other guidance in the standard that requires variable consideration and/or discounts to be allocated to one or more (but not all) performance obligations, if certain criteria for applying that guidance are met.[13]

How we see it

There likely will be significant judgment involved in determining whether a significant financing component exists when there is more than one year between the transfer of goods or services and the receipt of arrangement consideration. Entities will need to make sure that they have sufficiently documented their analyses to support their conclusions.

Guarantees of return on investment and seller support of operations

In certain real estate sales contracts, the seller may guarantee the return on, or of, the buyer's investment, while other arrangements may require that the seller initiate or support the property's operations. These two types of arrangements often may be confused, but the distinction is important under ASC 360-20.[14] An obligation to support the property's operations only guarantees that the buyer will recover funds from the seller related to the operating costs of the property for a period of time and does not guarantee that the buyer will receive a return on, or of, its investment.

Under ASC 360-20, if the seller guarantees a return of, or on, the buyer's investment, or agrees to support operations of the transferred real estate, sale accounting may be prohibited or profit may be reduced depending on several factors (e.g., duration and amount of the guarantees or support obligations). Depending on the terms, if the seller is not eligible for the full accrual method, the seller might account for the transaction under the deposit, financing, leasing or profit-sharing methods.

Under the new standard, guarantees included in a real estate sales arrangement are separated and accounted for using the guidance in ASC 460.

Unlike ASC 360-20, the new standard doesn't specify the accounting treatment for guarantees of return/investment or support obligations in contracts with customers. Instead, the seller determines whether these contract elements represent guarantees that are within the scope of ASC 460 (and not within the scope of ASC 606). If so, the seller recognizes a liability for the guarantee based on the estimated fair value and accounts for the guarantee as a separate element in the arrangement (i.e., the sale of real estate and sale of a guarantee). Although this is not explicit in ASC 610-20, entities that enter into these contracts with noncustomers will need to evaluate whether there are elements in the contract other than nonfinancial assets (or in substance nonfinancial assets) and account for those elements in accordance with the applicable literature (e.g., apply ASC 460 to guarantees provided in the contract).

Once the fair value of the guarantee has been determined, the remainder of the estimated arrangement consideration is allocated among the other elements in the arrangement (e.g., the sale of property, management arrangements, development services) in accordance with the revenue recognition standard. An entity recognizes a sale and associated profit when control of the property transfers, an assessment that is not affected by the presence of the guarantee.

The following illustration compares the accounting for an arrangement where the seller guarantees a return on the buyer's investment under ASC 360-20 and under the new revenue standard.

Illustration 8: Guarantee of return on buyer's investment

On 31 December 2018, Developer N sells a newly constructed apartment building with a cost of $1,200,000 to Buyer B for $2,000,000. Developer N guarantees that Buyer B will earn a minimum annual 10% profit in each of the next three years. Developer N's incremental borrowing rate is 5%.

Based on its experience with similar properties, Developer N forecasts that the property's operating results will be as follows:

	2019	2020	2021
Revenues	$ 300,000	$ 380,000	$ 400,000
Operating expenses	350,000	355,000	360,000
Profit (deficit)	(50,000)	25,000	40,000
10% profit	30,000	38,000	40,000
Guarantee requirement	80,000	13,000	N/A

Developer N transfers title to the building, and Buyer B takes possession of the property at the closing date. The sale also meets all of the other criteria for recognizing profit under the full accrual method in ASC 360-20, and Developer N has no other continuing involvement in the property.

Future GAAP analysis (ASC 606):

Developer N's ordinary activities include the construction and sale of real estate properties, thus the sale of the apartment building to Buyer B is a transaction with a customer within the scope of ASC 606.

Developer N concludes that it has provided a financial guarantee to Buyer B that is within the scope of ASC 460. ASC 606 states that Developer N must allocate a portion of the transaction price to the guarantee obligation in accordance with the measurement principles of ASC 460.

Assume that Developer N determines a guarantee obligation of $93,000 in accordance with ASC 460[15] and allocates that amount of consideration to the guarantee and records a liability. The remaining transaction price of $1,907,000 is allocated to the performance obligation representing the sale of the property. Developer N concludes that control of the property has transferred to Buyer B and records profit of $707,000 ($2,000,000 sale price — $93,000 guarantee liability — $1,200,000 cost basis) on the closing date.

Future GAAP analysis (ASC 610-20):

If the transaction illustrated above is with a noncustomer (e.g., the seller is a REIT that ordinarily owns and operates multifamily properties), ASC 610-20 would be applied to the sale of the building. ASC 610-20 does not include guidance similar to ASC 606 regarding the separation of units of accounting and allocation of transaction price to elements within a contract that are outside the scope of ASC 606 (e.g., guarantees). However, entities may have the same accounting result as a transaction with a customer under ASC 606 because the guidance in ASC 460 for guarantees would be applied.

Current GAAP analysis (ASC 360-20):

Because Developer N has guaranteed a return on Buyer B's investment, the deposit method should be applied to this transaction.

Repurchase agreements

Certain agreements for the sale of real estate may include provisions that require, or give an option to, the seller to repurchase the property. These provisions are generally structured in one of three ways:

- Forward option — An entity is obligated to repurchase the property
- Call option — An entity has the right to repurchase the property
- Put option — An entity is obligated to repurchase the property at the buyer's request

ASC 606 addresses the accounting for each of these repurchase provisions. ASC 610-20 does not explicitly refer to the repurchases guidance in ASC 606, but it does reference the transfer of control indicators in ASC 606-10-25-30, which incorporate the repurchases guidance. Therefore, repurchase agreements with customers and noncustomers should be evaluated using the repurchases guidance in ASC 606.

Forward or call option held by the entity

When an entity has the unconditional obligation or right to repurchase a property (i.e., a forward or call option), ASC 606 specifies that the buyer has not obtained control of the property even if the option is at fair value. Instead, the standard requires that an entity account for a transaction that includes a forward or a call option based on the relationship between the repurchase price and the original selling price.

If the entity has the right or obligation to repurchase the property at a price less than the original sales price (considering the effects of the time value of money), the entity would account for the transaction as a lease in accordance with ASC 840.

If the transaction is a sale-leaseback, the guidance in ASC 840-40 (including the guidance in ASC 360-20, which is retained only for sale-leaseback transactions until the Boards' project on lease accounting is finalized), would be applied.

In contrast, if the entity has the right or obligation to repurchase the property at a price equal to or greater than the original sales price (considering the effects of the time value of money), the entity would account for the arrangement as a financing arrangement. If a transaction is considered a financing arrangement, the selling entity would continue to recognize the property and record a financial liability for the consideration received from the customer. The difference between the consideration received from the customer and the consideration subsequently paid to the customer upon repurchase would represent the interest and holding costs, as applicable, that would be recognized over the term of the financing arrangement. If the option lapses unexercised, the entity derecognizes the property and financing liability and recognizes revenue at that time.

The concept of accounting for a forward or call option as a lease or financing arrangement is similar to existing guidance in ASC 360-20. However, under ASC 360-20, an entity can also apply the profit-sharing method if certain criteria are met. The new standard only allows a sale with a corresponding forward or call option to be treated as a lease or a financing arrangement and the likelihood of exercise is not contemplated in the accounting.

Illustration 9: Seller retains call option for amount greater than purchase price

Real Estate Fund E sells an office building to Buyer L on 1 January 2019 for $2.0 million. The contract includes a call option that gives Real Estate Fund E the right to repurchase the asset for $2.2 million on or before 31 December 2020. For simplicity, the time value of money is ignored in this example.

Future GAAP analysis (ASC 606/610-20):

Control of the asset does not transfer to Buyer L on 1 January 2019 because Real Estate Fund E has a right to repurchase the office building. Buyer L is therefore limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

As a result, Real Estate Fund E accounts for the transaction as a financing arrangement because the exercise price is more than the original selling price. Real Estate Fund E does not derecognize the office building and instead recognizes the cash received as a financial liability. Real Estate Fund E also accretes the liability and recognizes interest expense over the two-year period for the difference between the exercise price ($2.2 million) and the cash received ($2.0 million).

If the option subsequently lapses unexercised, the Real Estate Fund E derecognizes the office building and recognizes proceeds of $2.2 million.

Current GAAP analysis (ASC 360-20):

The repurchase option represents continuing involvement that prevents Real Estate Fund E from recognizing a sale or profit under the full accrual method at 1 January 2019. Real Estate Fund E evaluates the likelihood that it will exercise the option to determine whether to account for the transaction as a financing or profit-sharing arrangement.

Written put option held by the buyer

A real estate sales contract may give a buyer the ability to require the seller to repurchase the property at a previously agreed-upon price (i.e., a put option). Under ASC 606, a seller accounts for a contract that includes a put option using one of three methods (i.e., lease, sale with a right of return or financing arrangement) depending on the relationship of the exercise price to the original selling price of the property and whether the buyer has a significant economic incentive to exercise its right.

The determination of whether an entity has a significant economic incentive to exercise its right influences whether the buyer truly has control of the property. A seller has to consider many factors to determine whether a buyer has a significant economic incentive to exercise the put option, including the relationship of the repurchase price to the expected market value of the property at the date of repurchase and the amount of time until the option expires. The standard notes that if the repurchase price is expected to significantly exceed the market value of the property, the buyer has a significant economic incentive to exercise the put option.

How we see it

The new revenue standard does not provide guidance on determining whether the buyer has "a significant economic incentive" to exercise a put option. We believe entities that sell a property subject to a put option will need to estimate the future market price of the property and evaluate other facts and circumstances to determine whether the buyer has a significant economic incentive to exercise the option. This determination will require significant judgment.

A seller will account for a transaction that includes a buyer's put option as either a lease, a sale with a right of return or a financing arrangement.

- *Lease* — If the repurchase price is less than the original selling price and the buyer has a significant economic incentive to exercise the put option, the seller should account for the agreement as a lease because the buyer is effectively paying for the right to use the property for a period of time.
- *Sale with a right of return* — If the repurchase price is less than the original selling price and the buyer does not have a significant economic incentive to exercise its right, the seller should account for the agreement in a manner similar to a sale with a right of return. A repurchase price that is equal to or greater than the original selling price, but less than or equal to its expected market value, should also be accounted for as a sale of a product with a right of return if the customer does not have a significant economic incentive to exercise its right. Refer to Section 5.2.2 of our Technical Line publication, *A closer look at the new revenue recognition standard*, for a discussion of the accounting for the sale of a product with a right of return.
- *Financing arrangement* — If the buyer has the ability to require the seller to repurchase the property at a price that is equal to or greater than the original selling price and greater than the expected market value of the property, the contract is in effect a financing.

Illustration 10: Buyer holds put option with exercise price less than market value
Real Estate Fund E sells an office building to Buyer L on 1 January 2019 for $2.0 million. The contract includes a put option that obligates Real Estate Fund E to repurchase the building at Buyer L's request for $1.9 million on or before 31 December 2020. The market value of the office building is expected to be $1.8 million on 31 December 2020. *Future GAAP analysis (ASC 606/610-20):* At contract inception, Real Estate Fund E assesses whether Buyer L has a significant economic incentive to exercise the put option to determine whether the arrangement should be accounted for as a lease in accordance with ASC 840 or a sale with a right of return. Real Estate Fund E considers all relevant factors and concludes that Buyer L has a significant economic incentive to exercise the put option because the $1.9 million repurchase price significantly exceeds the expected market value of $1.8 million at the date of repurchase. Real Estate Fund E concludes that control of the building does not transfer to Buyer L because the significant economic incentive to exercise the put option limits Buyer L's ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Consequently, Real Estate Fund E accounts for the arrangement as a lease in accordance with ASC 840[16] on leases. *Current GAAP analysis (ASC 360-20):* The put option represents continuing involvement that prevents Real Estate Fund E from recognizing a sale or profit under the full accrual method at 1 January 2019. Real Estate Fund E determined that the leasing method described in ASC 360-20 was appropriate for this transaction. Any cash received from Buyer L equal to the repurchase price should be recorded as a liability with the difference between the cash received and the repurchase price representing deferred rental income that should be recognized ratably over the rental period.

Sales of real estate by real estate developers

Under the new standard, there is no special condominium accounting guidance. Instead, any developer may be able to recognize revenue over time (i.e., similar to the percentage-of-completion method) if it can determine that the asset (e.g., building, land parcel, residential unit) under construction has no alternative use and the developer has an enforceable right (throughout the contract) to payment from the customer for performance completed to date.

Real estate developers generally own the land and/or asset until title is transferred at completion of construction. Therefore, they must evaluate whether the asset has no alternative use and a present right to payment from the customer exists. In contrast, a construction contractor builds an asset on the customer's land and the customer owns the work-in-process, generally allowing the contractor to conclude that the customer controls the asset as it is created or enhanced.

Alternative use

An asset created by an entity has no alternative use if the entity is either restricted contractually or practically from readily directing the asset for another use (e.g., selling to a different customer). An entity has to make this assessment at contract inception and does not update its assessment unless the parties to the contract approve a contract modification that substantively changes the performance obligation.

The Boards specified[17] that a contractual restriction on an entity's ability to direct an asset for another use must be substantive (i.e., a buyer could enforce its rights to the promised asset if the entity sought to sell the unit to a different buyer). In contrast, a contractual restriction may not be substantive if the entity could instead sell a different asset to the buyer without breaching the contract or incurring significant costs.

Further, the Boards believe a practical limitation exists if an entity would incur significant economic losses to direct the asset for another use. A significant economic loss may arise when significant costs are incurred to redesign or modify an asset, or when the asset is sold at a significantly reduced price.

A developer may be able to determine that an asset has no alternative use because its characteristics (e.g., location, design, technical specifications, materials) would generally result in a contractual and/or practical limitation to redirect its use to another buyer.

Enforceable right to payment for performance completed to date

An entity has an enforceable right to payment for performance completed to date if, at any time during the contract term, the entity would be entitled to an amount that at least compensates it for work already performed. This enforceable right to payment must exist, even if the buyer can terminate the contract for reasons other than the entity's failure to perform as promised.

The laws or legal precedent of a jurisdiction may affect an entity's conclusion of whether a right to payment is enforceable.

To satisfy this criterion, the amount to which an entity is entitled must approximate the selling price of the goods or services transferred to date, including a reasonable profit margin. Compensation for a reasonable profit margin doesn't have to equal the profit margin expected for complete fulfillment of the contract but must at least reflect either of the following:

- A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party)
- A reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts

Entities are required to consider any laws, legislation or legal precedent that could supplement or override contractual terms. These may vary by country. In addition, the standard clarifies that including a payment schedule in a contract does not, by itself, indicate that the entity has the right to payment for performance completed to date. For example, progress billings collected from a customer may not reflect a reasonable profit margin on work completed to date. The entity has to examine information that may contradict the payment schedule and may represent the entity's actual enforceable right to payment for performance completed to date (e.g., an entity's legal right to continue to perform and enforce payment by the buyer if a contract is terminated without cause).

Measuring progress

When a performance obligation is satisfied over time, the standard allows the use of one of two methods for measuring progress under the contract: an input method or an output method. While the standard requires an entity to update its estimates related to the measure of progress selected, it does not allow a change in methods. A performance obligation is accounted for under the method the entity selects (i.e., either an input or output method) until it has been fully satisfied.

Under an input method, revenue is recognized "on the basis of the entity's efforts or inputs to satisfy the performance obligation … relative to the total expected inputs to the satisfaction of that performance obligation." The standard includes resources consumed, labor hours expended, costs incurred and time elapsed as possible input methods. The standard also notes it may be appropriate to recognize evenly expended inputs on a straight-line basis.

Under an output method, revenue is recognized "on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract." Measurements of output may include surveys of performance completed to date, appraisals of results achieved, milestones reached and time elapsed.

The standard does not say either type of method is preferable, but it says an entity should apply the method it selects to similar arrangements in similar circumstances. If an entity does not have a reasonable basis to measure its progress, the Boards decided that too much uncertainty would exist and, therefore, revenue should not be recognized until progress can be measured. However, if an entity cannot reasonably measure its progress, but expects it will not incur a loss, the new standard requires revenue to be recognized to the extent that costs are incurred until the entity is able to reasonably measure its progress.

The accounting for partial sales of real estate is not specifically addressed in the new standard.

How we see it

Many developers of residential condominium units currently recognize revenue using the percentage-of-completion method that is permitted in ASC 360-20 when certain criteria are met (e.g., construction is beyond a preliminary stage, buyer is unable to require a refund, sales price is collectible). This accounting treatment in ASC 360-20 is not available to other developers of real estate assets that are sold upon completion (e.g., build-to-suit commercial builders and land developers).

Under the new revenue standard, it may be difficult for developers of residential condominiums to conclude that their arrangements meet the criteria for revenue recognition over time. In many jurisdictions (e.g., the US) the developer receives an initial deposit from the buyer but is not entitled to further consideration until the sale of the unit closes. As a result, the developer may be unable to assert that it has an enforceable right to payment for performance completed to date at any point in the contract term.

Partial sales of real estate

Under ASC 360-20, a seller has made a partial sale of real estate if the seller has an equity interest in the buyer or retains an equity interest in the property. The nature of a partial sale of real estate indicates continuing involvement (i.e., retained ownership) in the property by the seller. However, ASC 360-20 allows a seller to recognize profit on the partial sale of real estate at the date of a sale if all other requirements for recognizing profit under the full accrual method have been satisfied. In addition, the seller must be independent of the buyer, and the seller cannot be required to support the operations of the property or its related obligations to an extent greater than its proportionate retained interest.

A partial sale of real estate may also occur if an entity contributes a property to a venture and withdraws cash from the venture that was contributed by another partner. For example, Investor X enters into a transaction with Investor Y in which Investor X contributes real estate with a fair value of $5,000 and Investor Y contributes $2,500 in cash, which Investor X immediately withdraws. The only asset in this venture is the real estate, and after the contributions and withdrawals, each investor has a 50% interest in the venture. Assuming Investor X is not committed to reinvest the $2,500 in the venture, the substance of this transaction is a sale of a one-half interest in the real estate by Investor X for $2,500 in cash.

The new guidance does not specifically address partial sales of real estate. It is unclear whether these transactions are in the scope of ASC 610-20, and thus generally follow the model in ASC 606, or whether existing guidance in another ASC topic (e.g., ASC 810, ASC 323, *Investments — Equity Method and Joint Ventures*) should be applied. If these transactions are within the scope of ASC 610-20, neither ASC 610-20 nor ASC 606 specifies how an entity would view a partial sale of real estate in the context of its evaluation of the indicators of control transfer. For example, absent a clarification by the FASB, some entities may evaluate whether they continue to control the *property* after the partial sale, while others may look to whether control of the *ownership interest* specified in the contract has transferred.

How we see it

The frequency of partial sales of real estate and the lack of clarity in the new guidance could lead to substantial diversity in practice when accounting for these transactions. The FASB has indicated that it may provide further guidance on this issue as part of its project on clarifying the definition of a business.

Contributions of real estate that are not in substance sales

Contributions of real estate by an investor to a real estate venture that are not in substance sales (as described above) will continue to be accounted for under existing guidance in ASC 970-323, *Real Estate — General*, *Investments — Equity Method and Joint Ventures*. This guidance states that an investor that contributes real estate to the capital of a real estate venture should generally record its investment at the book value of the real estate contributed and not recognize a profit on the transaction (i.e., the economic substance of the transaction is a contribution of capital and not a sale of real estate).

Surrender of real estate in satisfaction of an entity's obligation

ASU 2011-10, *Derecognition of in Substance Real Estate — a Scope Clarification,* clarified that the guidance in ASC 360-20 (rather than the derecognition provisions of ASC 810) should be applied to a parent that ceases to have a controlling financial interest in a subsidiary that is in substance real estate as a result of default on the subsidiary's nonrecourse debt.

The FASB's consequential amendments in ASU 2014-09 did not change the exclusion of these transactions from the derecognition provisions of ASC 810. However, entities will now apply the guidance in ASC 610-20 (and therefore the indicators of control transfer in ASC 606-10-25-30) when derecognizing all nonfinancial assets, including real estate, that are transferred in satisfaction of a subsidiary's default on nonrecourse debt.

Under ASC 360-20, derecognition of the in substance real estate by an entity is not appropriate before the date that the reporting entity's interest in the real estate is conveyed to the lender or a third-party purchaser and the subsidiary is released from its debt obligation. The indicators of transfer of control in the new standard include consideration of whether title to the property has transferred and the buyer or lender has obtained the significant risks and rewards of ownership. However, the standard does not specifically address whether the subsidiary must be legally released from its debt obligation in order to derecognize the property.

How we see it

The new revenue standard states that an entity's assessment of whether control of a property has transferred includes, but is not limited to, the five indicators in ASC 606-10-25-30. While we believe that the legal release of the debt obligation is an important factor in determining whether control of a property has transferred, diversity in practice could develop in this area because the standard does not specifically require that this condition be satisfied. Further, timing of transfer of control under ASC 606 may not coincide with the borrower's derecognition of the debt obligation in accordance with relevant debt extinguishment guidance.

Transition and effective date

The new standard is effective for public entities for fiscal years beginning after 15 December 2016 and for interim periods therein. It is effective for nonpublic entities for fiscal years beginning after 15 December 2017 and interim periods within fiscal years beginning after 15 December 2018, and they may elect to adopt the guidance as early as the public entity effective date. Under US GAAP, early adoption is prohibited for public entities.

The FASB voted to defer the effective date of the new standard for both public and nonpublic entities reporting under US GAAP for one year. As proposed, both public and nonpublic entities would be permitted to adopt the standard as early as the original public entity effective date. Early adoption prior to that date would not be permitted.

The IASB, which developed its new revenue standard jointly with the FASB, also voted to adopt a one-year deferral, which would keep the new standards' effective dates converged under IFRS and US GAAP.

All entities will be required to apply the standard retrospectively, either using a full retrospective or a modified retrospective approach. The Boards provided certain practical expedients to make it easier for entities to use a full retrospective approach.

Under the modified retrospective approach, financial statements will be prepared for the year of adoption using the new standard, but prior periods won't be adjusted. Instead, an entity will recognize a cumulative catch-up adjustment to the opening balance of retained earnings (or other appropriate component of equity or net assets) at the date of initial application for contracts that still require performance by the entity (i.e., contracts that are not completed). Entities will need to provide certain disclosures in the year of adoption, (e.g., entities using the modified retrospective approach must disclose the amount by which each financial statement line item is affected as a result of applying the new standard).

How we see it

Entities with deferred revenue balances or failed sales from real estate sales that predate their adoption of the new standard may experience "lost revenue." That's because the deferred amounts or previously unrecognized sales will be reflected in the recasted prior periods (under the full retrospective approach) or as part of the cumulative effect adjustment upon adoption (under the modified retrospective approach), but never reported as revenue in a current period within the financial statements.

The illustration below compares the application of the two transition approaches to a real estate sale for which profit was previously deferred under the installment method. Real estate entities that have previously deferred profit from a sale under another method in ASC 360-20 will need to consider specific transition issues that may arise from each respective method (e.g., interest expense and/or continued depreciation of the property under any of the financing, leasing, profit-sharing or deposit methods).

Illustration 11: Comparison of transition approaches

Developer A, a public entity with a 31 December fiscal year-end, sold a real estate property with a carrying value of $6 million for net proceeds of $11 million. The sale closed on 31 December 2015 but did not qualify for full accrual profit recognition because the terms of the four-year note receivable (i.e., seller financing) provided by Developer A did not meet the initial and continuing investment criteria in ASC 360-20. Under ASC 360-20, Developer A applied the installment method and determined that $1 million of profit should be recognized at the sale date, $1 million in 2016, $1 million in 2017 and $2 million in 2018 when the initial and continuing investment criteria were expected to be satisfied. Developer A will also recognize interest income from the note as it is received.

The illustration assumes that the new revenue standard is effective for Developer A for interim and annual periods beginning 1 January 2018. Management evaluates the new revenue standard and concludes that the terms of the seller financing would not have precluded the recognition of the $5 million of profit at the date of sale (i.e., the transaction price is probable of collection, control of the property has transferred).

Full retrospective approach

Developer A presents three years of comparative financial information in its 2018 annual filings with the Securities and Exchange Commission (SEC). In accordance with ASC 250,[18] the full $5 million of profit from the sale that occurred on 31 December 2015 would be recorded as a cumulative catch-up to retained earnings as of 1 January 2016 in the recasted financial information. Deferred profit of $1 million that was previously recognized in both 2016 and 2017 would no longer be included in the income statements of each respective period.

Quarterly SEC filings of Developer A will also reflect this presentation beginning 31 March 2018.

Modified retrospective approach

The sale of the property by Developer A constitutes a completed contract as defined in the new standard[19] because the property was transferred on 31 December 2015, before the date of initial application by the entity. Under the modified retrospective approach, the new standard is only applied to contracts that are in progress at the date of initial application (i.e., 1 January 2018). Therefore, Developer A would recognize the remaining $2 million of deferred revenue at 1 January 2018 as a cumulative catch-up to retained earnings at the beginning of the period. In contrast to the results under the full retrospective approach, the $1 million of deferred revenue recognized in both 2016 and 2017 continues to be reflected in each respective comparative period.

Developer A also must disclose the $2 million of profit that would have been recognized in 2018 had ASC 360-20 remained in effect.

The new standard defines a completed contract as one in which the entity has fully transferred all of the identified goods and services in accordance with today's revenue guidance before the date of initial application. However, some have questioned whether the Boards actually intended for a contract for which revenue is not yet fully recognized (e.g., a sale of real estate accounted for under one of the alternative methods in ASC 360-20) at the date of transition to be considered a completed contract. The TRG has discussed this issue and the Boards' staffs are working to summarize and clarify the Boards' intent. The answer to what constitutes a completed contract may change the accounting described in Illustration 11. Entities that are currently accounting for the sale of real estate using one of the alternative methods in ASC 360-20 should monitor the activities of the TRG and Boards.

Next steps

It is important for entities to continue to focus on their implementation plans. They should not postpone plans because the FASB has voted for a one-year deferral. Many entities are finding it more difficult to apply the new standard than they initially expected.

Entities should also continue to monitor the discussions of the Boards, SEC staff, the TRG, and hospitality and time-shares industry task forces formed by the AICPA to discuss interpretations and application of the new standard to common transactions. These groups may address issues that affect all real estate entities. In addition, the Board's project to clarify the definition of a business may also result in changes in the accounting for sales of real estate.

Endnotes:

[1] The term customer is defined in ASC 606 as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." Throughout this paper, the term "customer" may be used in reference to a transaction under ASC 610-20 in which the counterparty is a "buyer" and not a customer as contemplated in ASC 606. The use of "customer" in such instances is because ASC 610-20 refers to the guidance in ASC 606 and the discussion is focused on the requirements of ASC 606.

[2] In March 2015, the FASB voted to propose amending its standard to refine the guidance in the Step 1 collectibility threshold and/or add or amend examples to clarify how the threshold should be applied. The FASB staff is in the process of drafting an Exposure Draft to reflect these tentative conclusions.

[3] ASU 2014-09, *Basis for Conclusions,* paragraph 129.

[4] ASU 2014-09, *Basis for Conclusions,* paragraph 132.

[5] This exclusion includes contracts within the scope of the following Topics: ASC 310, *Receivables*; ASC 320, *Investments — Debt and Equity Securities*; ASC 405, *Liabilities*; ASC 470, *Debt*; ASC 815, *Derivatives and Hedging*; ASC 825, *Financial Instruments*; and ASC 860, *Transfers and Servicing*.

[6] Neither ASC 606 nor ASC 460 provides guidance on recognizing revenue associated with a guarantee.

[7] Statement of Financial Accounting Concepts No. 6, *Elements of financial statements*.

[8] ASU 2014-09, *Basis for Conclusions,* paragraph 497.

[9] ASC 810-10-40-3A and ASC 810-10-40-5.

[10] For further information about the phases and status of the FASB's project, *Clarifying the Definition of a Business*, refer to the Board's technical agenda at www.fasb.org.

[11] ASU 2014-09, *Consequential Amendments*, paragraph 63.

[12] ASC 606-10-32-8.

[13] For further discussion, refer to our publication, *Joint Transition Resource Group for Revenue Recognition (TRG) items of general agreement* (SCORE No. BB2927).

[14] ASC 360-20-40-41 to ASC 360-20-40-44.

[15] The $93,000 guarantee value is used in this scenario for illustrative purposes only and may not accurately consider the measurement guidance of ASC 460.

[16] The FASB and IASB are jointly deliberating a new leases standard. A final standard is expected in 2015 but an effective date for the new guidance has not been determined.

[17] ASU 2014-09, *Basis for Conclusions,* paragraphs 134–141.

[18] ASC 250-10-45-5.

[19] ASC 606-10-65-1(c)(2).

No. 2015-02
Updated 28 July 2015

Technical Line

FASB — proposed guidance

Final standard on leases is taking shape

The new standard could affect companies' decisions about whether to lease or buy assets.

What you need to know

- The FASB and the IASB have substantially completed redeliberations on new leases standards that would require lessees to recognize assets and liabilities for most leases.
- Lessees and lessors applying US GAAP would classify most leases using a principle generally consistent with that of IAS 17, which is similar to current US GAAP but without the bright lines.
- The Boards have made different decisions about lease classification and the recognition, measurement and presentation of leases for lessees and lessors. In some cases, these differences would result in similar transactions being accounted for differently under US GAAP and IFRS.
- The Boards will set effective dates before issuing the new standards. We expect the Boards to issue the standards in the fourth quarter of 2015.

Overview

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) have substantially completed redeliberations on new standards that would significantly change the accounting for leases and could have far-reaching implications for a company's finances and operations. This Technical Line is based on the FASB's decisions in redeliberations and supersedes the Technical Line with the same title that we issued on 25 March 2015.

Building a better working world

The standards the FASB and the IASB plan to issue would require lessees to recognize most leases on their balance sheets as lease liabilities with corresponding right-of-use assets. While many aspects of lessor accounting would remain the same, the standard that the FASB plans to issue (the new standard) would eliminate today's real estate-specific guidance and change today's additional lessor classification criteria.[1] It also would change what would be considered initial direct costs. The new standards would incorporate feedback the Boards received from constituents on their 2013 exposure draft[2] (2013 ED).

Like today's guidance in Accounting Standards Codification (ASC) 840, *Leases*, the new standard would require lessees to classify most leases. Leases would be classified as either Type A leases (generally today's capital leases) or Type B leases (generally today's operating leases). As discussed later in this publication, the IASB has decided that lessees would apply a single model for all recognized leases and would have the option not to recognize and measure leases of small assets.

The new standard would require lessors to classify all leases as either Type A leases or Type B leases (generally today's operating leases). There would be three categories of Type A leases for lessors: (1) those with selling profit that is recognized or deferred (generally today's sales-type leases), (2) those with no selling profit (generally today's direct financing leases), and (3) certain leases where collectibility of lease payments is not probable. Leases in the latter category would be recognized and measured in accordance with the new revenue recognition standard (i.e., ASC 606, *Revenue from Contracts with Customers)*. As discussed later in this publication, the IASB also has decided that lessors would apply a dual classification model for all leases.

Leases would be classified using a principle generally consistent with that of International Accounting Standards (IAS) 17, *Leases*, which is similar to US GAAP but without today's bright lines (i.e., the "75% of economic life" and "90% of fair value" tests in ASC 840). The new standard would eliminate today's real estate-specific guidance and would change today's additional lessor classification criteria. Lease classification would be important in determining how and when a lessee and a lessor would recognize lease expense and revenue, respectively, and what assets a lessor would record.

For lessees, the income statement recognition pattern for Type A leases would be similar to that of today's capital leases. The income statement recognition pattern for Type A leases for lessors would be similar to that of today's sales-type or direct financing leases. However, lessors would also evaluate whether a Type A lease, in effect, transfers control of the underlying asset to the lessee when determining whether to recognize or defer recognition of any profit. In addition, for some Type A leases, the recognition and measurement provisions of ASC 606 would apply.

Lessees' and lessors' income statement recognition patterns for Type B leases would be similar to today's patterns for operating leases.

For lessees, recognizing lease-related assets and liabilities could have significant financial reporting and business implications, such as:

- Key balance sheet metrics could change.
- Debt covenants and borrowing capacity might be affected.
- Decisions about whether to lease or buy significant assets might change.

As discussed in Appendix B to this publication, the new standard would eliminate the following lease and lease-related accounting guidance:

- Lessee involvement in asset construction ("build-to-suit" transactions)
- Separate requirements for leases involving real estate
- Leveraged leases that are not grandfathered upon transition

Before issuing a final standard, the FASB plans to revisit interpretive guidance in ASC 840 to determine whether to carry forward guidance it did not include in its 2013 ED. This could result in certain guidance being carried forward to the new standard, such as the following:

- Sale of assets subject to a lease or intended to be leased by the purchaser to a third party
- Lessee maintenance deposits
- The sale of tax benefits associated with a leased asset
- Accounting for a loss on a sublease

The FASB has not yet discussed an effective date but plans to address it before issuing a final standard. Given the current timeline, an effective date of 1 January 2018 or later is likely.

The new standard's transition provisions would be applied using a modified retrospective approach at the beginning of the earliest comparative period presented in the financial statements. For example, if the standard is effective for 2018 for calendar-year companies, a company that presents three years of financial statements would have an effective date of 1 January 2018 and would apply the transition provisions to periods beginning 1 January 2016. Full retrospective application would be prohibited.

This publication discusses how the FASB's standard would be applied and is intended to help companies consider the effects of adopting it. Please note that our publication is based on available information regarding the FASB's decisions in redeliberations. Until a final standard is issued, these decisions are tentative. The FASB may also clarify its decisions in the final standard. The discussions and illustrations in this publication represent our preliminary thoughts.

Contents

Identifying a lease

Scope and scope exclusions (updated July 2015)

The scope of the new standard would be broader than the scope of ASC 840 and would not be limited to leases of property, plant and equipment. The new standard would apply to leases of all assets, except for the following:

- Leases of intangible assets
- Leases to explore for or use natural resources (e.g., minerals, oil, natural gas, similar non-regenerative resources)
- Leases of biological assets, including timber

How we see it

We believe that service concession arrangements[3] within the scope of ASC 853, *Service Concession Arrangements,* would be outside the scope of the new standard because they are currently excluded from the scope of today's guidance on leases. The FASB did not address them in the 2013 ED (and did not discuss them in redeliberations) because ASC 853 was codified after the FASB issued the ED.

A lease conveys the right to control the use of an identified asset.

Key differences between US GAAP and IFRS

Under the IASB's new standard, lessees of intangible assets could, as a policy election, apply the new lease standard, but they would not be required to. However, the IASB's new standard would specifically exclude lessors' leases of intangible assets from its scope.

Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

The requirement in ASC 350-40, *Intangibles — Goodwill and Other — Internal-Use Software,* that required licensees to analogize to ASC 840 for purposes of determining the accounting for a software licensing arrangement was eliminated by Accounting Standards Update (ASU) 2015-05.[4] Instead, customers will account for software licenses that are in the scope of ASC 350-40 in the same manner as licenses of other intangible assets.

Definition of a lease

A lease would be defined as a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations) that conveys the right to use an asset (i.e., the underlying asset) for a period of time in exchange for consideration. To be a lease, a contract would have to meet both of the following criteria:

- Fulfillment of the contract depends on the use of an identified asset.
- The contract conveys the right to control the use of the identified asset.

Identified asset

The FASB indicated that a contract's dependence on an identified asset is fundamental to the definition of a lease. This concept is generally consistent with the "specified asset" concept in ASC 840. Under the new standard, an identified asset could be either implicitly or explicitly specified in a contract and could be a physically distinct portion of a larger asset (e.g., a floor of a building). However, a capacity portion of an asset that is less than substantially all of that asset's capacity (e.g., 60% of a pipeline's capacity) would not be an identified asset because it is not physically distinct from the remaining capacity of the asset.

Illustration 1 — Identified asset

Scenario A

Assume that Customer X enters into a 12-year contract for the right to use a specified capacity of a supplier's data transmission within a fiber optic cable between New York and London. The contract identifies 3 of the cable's 20 fibers. The 3 fibers are dedicated solely to Customer X's data for the duration of the contract term.

Analysis: The 3 fibers would be identified assets because they are specified in the contract and are physically distinct from the other 17 fibers in the cable.

Scenario B

Assume the same facts as in Scenario A, except that the supplier is free to use any of the cable's 20 fibers, at any time during the contract term, to transmit any of its customers' data, including Customer X's data.

Analysis: The fibers are not identified assets because the contract allows the supplier to use any of the cable's 20 fibers to fulfill its obligations to Customer X, whose portion of the cable's capacity is not physically distinct from the cable's remaining capacity.

A contract would not involve the use of an identified asset if a supplier has the substantive right to substitute the asset used to fulfill the contract. A substitution right would be substantive if both of the following conditions are met:

- The supplier has the practical ability to substitute the asset.
- The supplier can benefit from exercising the right to substitute the asset.

A customer would presume that fulfillment of a contract depends on the use of an identified asset when it is impractical for the customer to evaluate either of these conditions. No presumption for suppliers is necessary because they generally have sufficient information to make such a determination.

Contract terms that allow or require a supplier to substitute other assets only when the underlying asset is not operating properly (e.g., a normal warranty provision) or when a technical upgrade becomes available would not create a substantive substitution right.

The FASB intends for the conditions above to mitigate the risk that customers and/or suppliers would structure arrangements with non-substantive substitution clauses to avoid applying lease accounting.

Illustration 2 — Substitution rights

Scenario A

Assume that an electronic data storage provider (supplier) provides services, through a centralized data center, that involve the use of a specified server (Server No. 9). The supplier maintains many identical servers in a single, accessible location and is permitted to and can easily substitute another server without the customer's consent. Further, the supplier would benefit from substituting an alternative asset, because it allows the supplier flexibility to optimize the performance of its network while incurring only nominal cost.

Analysis: Fulfillment of this contract would not depend on the use of an identified asset. Specifically, the supplier has the practical ability to substitute the asset and would benefit from such a substitution.

Scenario B

Assume the same facts as in Scenario A except that Server No. 9 is customized, and the supplier would not have the practical ability to substitute the customized asset. Additionally, the supplier would not obtain any benefits from sourcing a similar alternative asset. For example, the server may contain the customer's confidential information, requiring the destruction of the asset's primary components (e.g., hardware, software) adding significant costs to the supplier without benefiting the supplier, if substituted.

Analysis: Because it is not practical for the supplier to substitute the asset and the supplier would not benefit from substituting the asset, the substitution right would be non-substantive, and Server No. 9 would be an identified asset. In this scenario, neither of the conditions is met, but it is important to note that both conditions must be met for the supplier to have a substantive substitution right.

How we see it

The requirement that a substitution right must benefit the supplier in order to be substantive is a new concept that could disqualify substitution rights from being considered substantive.

Determining when a customer has the right to direct the use of the identified asset may require judgment.

Right to control the use of the identified asset

A contract would convey the right to control the use of an identified asset if, throughout the contract term, the customer has the right to both:

- Direct the use of the identified asset
- Obtain substantially all of the potential economic benefits from directing the use of the identified asset

Requiring a customer to have the right to direct the use of an identified asset would be a change from ASC 840. A contract may meet ASC 840's control criterion if, for example, the customer obtains substantially all of the output of an underlying asset. Under the new standard, these arrangements would no longer be considered leases unless the customer also has the right to direct the use of the identified asset.

Right to direct the use of the identified asset

A customer has the right to direct the use of an identified asset whenever it has the right to direct how and for what purpose the asset is used, including the right to change how and for what purpose the asset is used, throughout the period of use.

The determination of whether a customer has the right to direct how and for what purpose an asset is used should focus on whether the customer has the right to make the decisions that most significantly affect the economic benefits that can be derived from the use of the underlying asset. This right may include directing how, when, whether and where the asset is used and what it is used for throughout the contract term. Importantly, this right would permit the customer to change its decisions throughout the contract term without approval from the supplier. The customer would not necessarily need the right to operate the underlying asset to have the right to direct its use. That is, the customer may direct the use of an asset that is operated by the supplier's personnel.

If neither the customer nor the supplier directs how and for what purpose the asset is used throughout the period of use (e.g., when the contract specifies how and for what purpose the asset is used or when decisions are made jointly throughout the period of use), the customer would have the right to direct the use of the identified asset in either of the following circumstances:

- The customer has the right to operate the asset or direct others to operate the asset in a manner that it determines (with the supplier having no right to change those operating instructions).
- The customer designed the asset, or caused it to be designed, in a way that predetermines how and for what purpose the asset will be used or how the asset will be operated.

A supplier's protective rights, in isolation, would not prevent the customer from having the right to direct the use of an identified asset. The FASB believes that protective rights typically define the scope of the customer's use of the asset without removing the customer's right to direct the use of the asset. Protective rights are intended to protect a supplier's interests (e.g., interests in the asset, its personnel, compliance with laws and regulations) and might take the form of a specified maximum amount of asset use or a requirement to follow specific operating instructions.

How we see it

- We understand that the FASB does not intend for the assessment of whether a customer has the right to direct "how" and "for what purpose" an asset is used to be two separate determinations. Instead, the assessment would be holistic, encompassing how, when, whether and where an asset is used and what it is used for (including the right to change these decisions) throughout the period of its use.
- We still have questions about how the definition would be applied to certain arrangements. For example, in contracts that include significant services, we believe that determining whether the contract conveys the right to direct the use of an identified asset may be challenging.

Illustration 3 — Right to direct the use of an asset

Customer enters into a contract with Supplier to use Automobile A for a three-year period. Automobile A is specified in the contract. Supplier cannot substitute another vehicle unless Automobile A is not operational (e.g., it breaks down).

Under the contract, Customer operates Automobile A (i.e., drives the vehicle) or directs others to operate Automobile A (e.g., hires a driver). Customer decides how to use the vehicle (within contractual limitations, discussed below). In addition, Customer decides where Automobile A goes as well as when or whether it is used, and what it is used for, throughout the period of use. Customer can also change its decisions throughout the period of use.

Under the contract, Supplier provides scheduled maintenance services and specifies that Customer can use Automobile A for a maximum of 12,000 miles per year without a substantive penalty. In addition, Supplier prohibits certain uses of Automobile A (e.g., moving it overseas) and modifications of Automobile A to protect its interest in the asset.

Analysis: Customer has the right to direct the use of Automobile A. Customer has the right to direct how the vehicle is used, when or whether the vehicle is used, where the vehicle goes and what the vehicle is used for. Customer also has the right to change the aforementioned decisions.

Supplier's limits on annual mileage and certain uses for the vehicle are considered protective rights that define the scope of Customer's use of the asset but do not affect the assessment of whether Customer directs the use of the asset.

Right to obtain substantially all of the potential economic benefits from directing the use of the identified asset

A customer's right to control the use of an identified asset also depends on its right to obtain substantially all of the potential economic benefits from directing the use of the asset during the contract term. The customer can obtain economic benefits either directly or indirectly through the asset's primary outputs (i.e., goods or services) and any byproducts (e.g., renewable energy credits). However, other tax benefits, such as those related to the ownership of the asset (e.g., excess tax depreciation benefits), would not be considered potential economic benefits of use.

How we see it

The term "substantially all" was not defined in the 2013 ED and was not addressed during redeliberations. However, entities might consider the term to mean more than 90%, based on how it is defined in ASC 840 in the context of sale and leaseback transactions. That definition states that "if the present value of a reasonable amount of rental for the leaseback represents 10 percent or less of the fair value of the asset sold, the seller-lessee would be presumed to have transferred to the purchaser-lessor the right to substantially all of the remaining use of the property sold."

The FASB decided against including an additional requirement that, for a contract to contain a lease, a customer must have the ability to derive benefits from directing the use of an identified asset on its own or together with other resources (e.g., goods or services) that are either sold separately (by the supplier or any other supplier) or can be sourced in a reasonable period of time. Some members of the FASB indicated that such a requirement would have made applying the definition more complex, and the costs would have outweighed the benefits. They also noted that the FASB's staff was unable to identify arrangements in which the conclusion would change as a result of the additional requirement.

Cancelable leases

The new standard would apply to contracts that are referred to as "cancelable," "month-to-month," "at will," "evergreen," "perpetual" or "rolling" if they create enforceable rights and obligations. Any noncancelable periods in contracts meeting the definition of a lease would be considered part of the lease term. See the lease term section below.

For example, consider an agreement with an initial noncancelable period of one year and an extension for an additional year if both parties agree. The initial one-year noncancelable period would meet the definition of a contract because it creates enforceable rights and obligations. However, the one-year extension period would not be a contract because either party could unilaterally elect to not extend the arrangement without incurring a substantive penalty.

Short-term leases

Lessees could make an accounting policy election (by class of underlying asset) to apply a method similar to current operating lease accounting to leases with a lease term of 12 months or less (short-term leases). To evaluate whether a lease qualifies for this accounting, the lease term would be determined in a manner consistent with the lease term of all other leases. For example, the lease term would only include periods covered by lease renewal options that a lessee is reasonably certain to exercise and would also include periods covered by lease termination options that a lessee is reasonably certain not to exercise. See the lease term section below.

Illustration 4 — Short-term lease
Scenario A A lessee enters into a lease with a nine-month noncancelable term with an option to extend the lease for four months. At the lease commencement date, the lessee concludes that it is reasonably certain to exercise the extension option because the monthly lease payments during the extension period are significantly below market rates. *Analysis*: The lease term is greater than 12 months (i.e., 13 months). Therefore, the lessee may not account for the lease similar to operating lease accounting under ASC 840 today. Scenario B A lessee enters into a lease with a nine-month noncancelable term with an option to extend the lease for four months. At the lease commencement date, the lessee concludes that it is not reasonably certain to exercise the extension option because the monthly lease payments during the optional extension period are at market rates and there are no other factors that would make exercise of the renewal option reasonably certain. *Analysis*: The lease term is 12 months or less (i.e., nine months). Therefore, the lessee may (subject to its accounting policy, by class of underlying asset) account for the lease in a manner similar to an operating lease under ASC 840 today.

The short-term lease accounting policy election is intended to reduce the cost and complexity of applying the new standard. Lessees making the election would recognize lease expense on a straight-line basis over the lease term. Although such leases would not be recognized on the balance sheet, they would still meet the definition of a lease. As such, certain quantitative and qualitative disclosures would be required for short-term leases if a lessee makes such a policy election.

How we see it

- In its 2013 ED, the FASB proposed making the short-term lease accounting policy election available to lessees and lessors. However, given the FASB's decisions on lessor accounting, we believe the election will not be available to lessors in the final standard.
- The 2013 ED also said that any lease that contains a purchase option would not be considered a short-term lease. Because the FASB did not discuss this provision during redeliberations, it appears that such leases would not be short-term leases under the new standard.

Leases of small assets (IFRS-only)

Key differences between US GAAP and IFRS
The IASB's new standard would include an exemption from its recognition and measurement provisions for leases of small assets for lessees. The IASB's new standard would specify that the exemption only applies to leases of assets that are not dependent on, or highly interrelated with, other leased assets. The Basis for Conclusions to the IASB's new standard would include a discussion of the quantitative threshold that the IASB considers appropriate in applying the exemption. In its redeliberations, the IASB discussed a threshold of $5,000. This was intended to help preparers determine what is meant by "small" and would be expressed in terms of the value of the underlying asset when new. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Identifying and separating lease and non-lease components and allocating contract consideration

Identifying and separating lease from non-lease components of contracts

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). For these contracts, the non-lease components would be identified and accounted for separately from the lease component (except when a lessee applies the practical expedient as discussed below). The non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to the new revenue recognition standard (i.e., ASC 606, *Revenue from Contracts with Customers*) by lessors (suppliers).

How we see it

Identifying non-lease components of contracts may change practice for some lessees. Today, entities may not focus on identifying lease and non-lease components because their accounting treatment (e.g., the accounting for an operating lease and a service contract) is often the same. However, because most leases would be recognized on the balance sheet under the new standard, lessees may need to put more robust processes in place to identify the lease and non-lease components of contracts.

Lessees could make a policy election to account for a lease and non-lease components as a single lease component.

Activities or lessor costs in a contract that do not provide the lessee with an additional good or service would not be considered lease or non-lease components, and lessees and lessors would not allocate contract consideration (discussed below) to these activities or costs. An example would be administrative costs a lessor charges a lessee. However, activities or lessor costs such as a lessor providing services (e.g., maintenance, supply of utilities) or operating the underlying asset (e.g., vessel charter, aircraft wet lease) would generally represent non-lease components.

Under current US GAAP, lease-related executory costs (e.g., insurance, maintenance, taxes) are considered part of lease components (or lease elements) for the purpose of separating lease and non-lease elements. However, under the new standard, certain lease-related executory costs, such as maintenance activities, would be non-lease components. Additionally, arrangements that include payments for other items such as taxes and insurance would have to be evaluated to determine whether an additional good or service is being provided to the lessee and whether those items should be considered lease or non-lease components.

Practical expedient — lessees

The new standard would provide a practical expedient that would permit lessees to make an accounting policy election (by class of underlying asset) to account for the lease and non-lease components of a contract as a single lease component. The FASB expects the practical expedient to most often be used when the non-lease components of a contract are not significant when compared with the lease components of a contract.

Lessees that make the policy election to account for the lease and non-lease components of contracts as a single lease component would allocate all of the contract consideration to the lease. Therefore, the initial and subsequent measurement of the lease liability and right-of-use asset would be higher than if the policy election were not applied. See the lessee accounting section below for a discussion of measurement of lease liabilities and right-of-use assets.

Identifying and separating lease components

For contracts that contain the rights to use multiple assets (e.g., a building and equipment), the right to use each asset would be considered a separate lease component if both of the following criteria are met:

- The lessee can benefit from the use of the asset either on its own or together with other readily available resources (i.e., goods or services that are sold or leased separately, by the lessor or other suppliers, or that the lessee has already obtained from the lessor or in other transactions or events).
- The underlying asset is neither dependent on, nor highly interrelated with, the other underlying assets in the contract.

If one or both of these criteria are not met, the right to use multiple assets would be considered a single lease component.

Illustration 5 — Identifying and separating lease components

Scenario A

Assume that a lessee enters into a lease of a warehouse and the surrounding parking lot that is used for deliveries and truck parking. The lessee is a local trucking company that intends to use the warehouse as the hub for its shipping operations.

Analysis: The contract contains one lease component. The lessee would be unable to benefit from the use of the warehouse without also using the parking lot. Therefore, the warehouse space is dependent upon the parking lot.

Scenario B

Assume the same facts as in Scenario A, except that the contract also conveys the right to use an additional plot of land that is adjacent to the parking lot. This plot of land could be developed by the lessee for other uses (e.g., to construct a truck maintenance facility).

Analysis: The contract contains two lease components: a lease of the warehouse (together with the parking lot) and a lease of the adjacent plot of land. Because the adjacent land could be developed for other uses independent of the warehouse and parking lot, the lessee can benefit from the adjacent plot of land on its own or together with other readily available resources. The lessee can also benefit from the use of the warehouse and parking lot on its own or together with other readily available resources.

Allocating contract consideration

Lessees that do not make an accounting policy election to use the practical expedient to account for a lease and non-lease components of a contract as a single lease component would allocate contract consideration to the lease and non-lease components on a relative standalone price basis. Lessees would use observable standalone prices (i.e., prices that the lessor or a similar supplier would charge separately for a similar lease, good or service component of a contract) when available. If observable standalone prices are not available, lessees would be permitted to estimate standalone prices. In doing so, lessees would be required to maximize the use of observable information and to apply estimation methods in a consistent manner. This would be similar to how lessees allocate contract consideration under current US GAAP.

Lessors would be required to apply the new revenue recognition standard (i.e., ASC 606) to allocate contract consideration between the lease and non-lease components of a contract.

Allocating contract consideration — reassessment

Lessees would be required to reallocate consideration upon either:

- A contract modification that is not accounted for as a separate, new lease
- A reassessment of the lease term or a lessee's purchase option (i.e., whether the lessee is reasonably certain to exercise the option)

How we see it

Although the FASB decided to require lessees to reallocate contract consideration upon the reassessment of the lease term or a lessee's purchase option, we believe the FASB intended for lessees to reallocate contract consideration only when a reassessment results in a change to either the lease term or to the lessee's conclusion about whether it is reasonably certain that the lessee will exercise a purchase option.

Lessors would be required to reallocate contract consideration upon a modification that is not accounted for as a separate, new lease.

Modifications resulting in a separate, new lease for lessors and lessees would require consideration to be allocated to the lease and non-lease components (as applicable), as with any new lease. See the lease modifications section below.

Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

Lease modifications (updated July 2015)

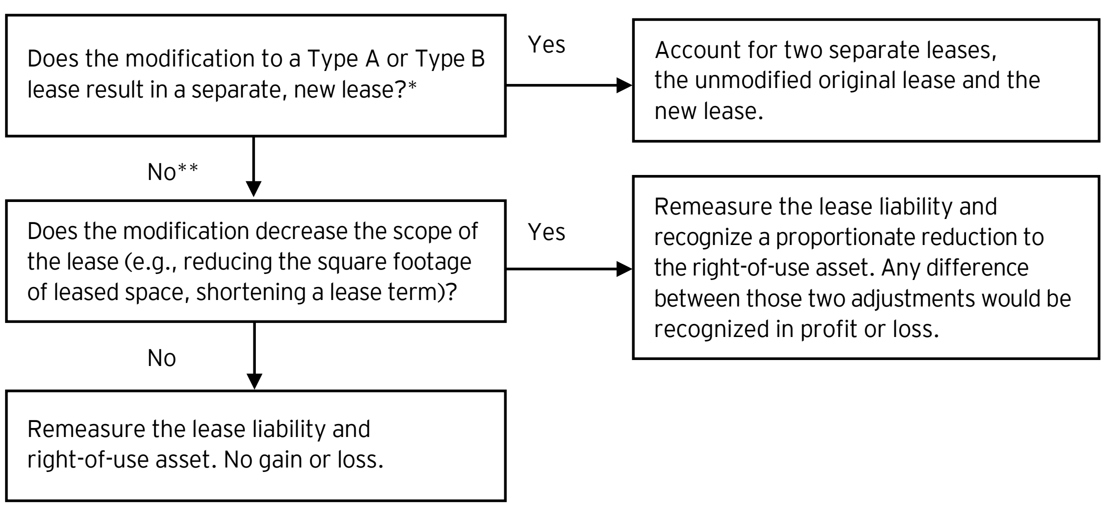
The new standard would define a lease modification as any change to the contractual terms and conditions of a lease that was not part of the original terms and conditions of the lease.

Lessees and lessors would account for a lease modification as a separate, new lease when both of the following conditions are met:

- The modification grants the lessee an additional right-of-use (e.g., an additional underlying asset, the same underlying asset for an additional period of time not contemplated by a renewal option) not included in the original lease.
- The additional right-of-use is priced commensurate with its standalone price.

This type of modification would result in a lessee and lessor accounting for two separate leases, the unmodified original lease and the new lease.

The following decision tree summarizes how lessees would evaluate and account for a lease modification under the new standard:



* Guidance for evaluating whether a modification results in a separate, new lease is discussed above.

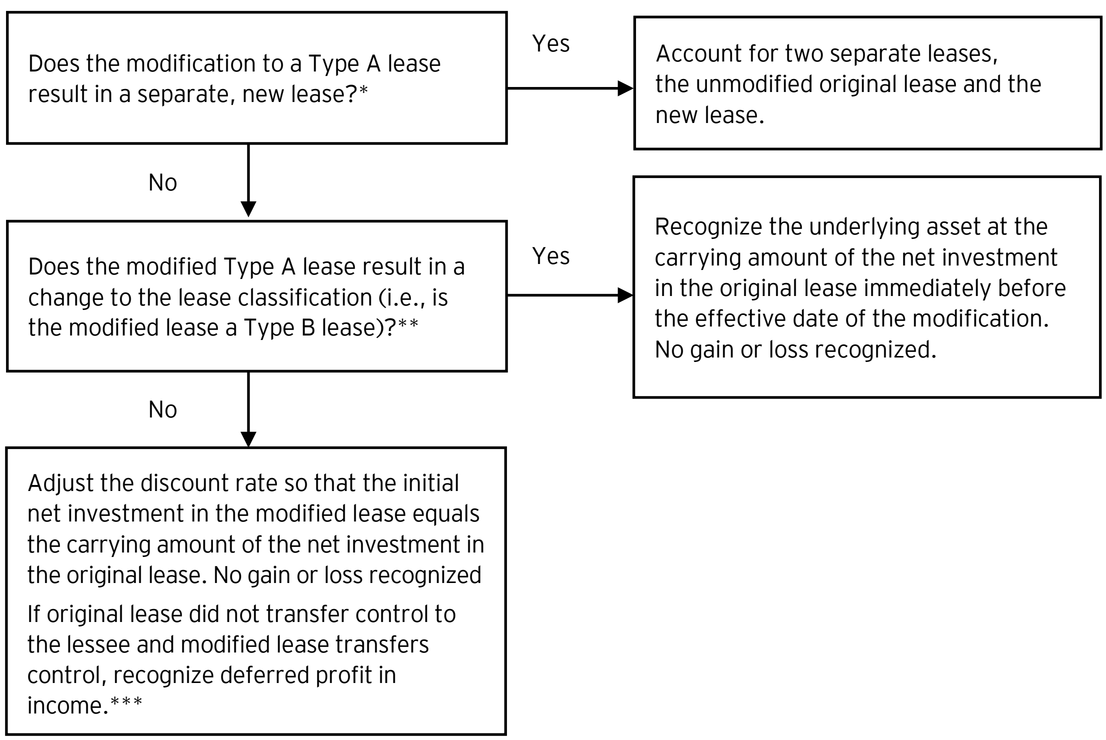
** It is unclear whether the final standard would require lessees to reassess lease classification upon a modification to a Type A or a Type B lease that does not result in a separate, new lease.

As indicated on the decision tree above, for a lease modification that does not result in a separate, new lease, lessees would generally remeasure the existing lease liability and right-of-use asset without affecting profit or loss. However, for a modification that decreases the scope of a lease (e.g., reducing the square footage of leased space, shortening a lease term), lessees would remeasure the lease liability and recognize a proportionate reduction (e.g., the proportion of the change in the lease liability to the pre-modification lease liability) to the right-of-use asset. Any difference between those adjustments would be recognized in profit or loss.

For lessors, a modification that does not result in a separate, new lease (as noted above) would be accounted for as follows:

- A modification to a Type B lease would be, in effect, a new Type B lease. The lease payments would be equal to the remaining lease payments of the modified lease, adjusted for any prepaid or accrued rent from the original lease.
- The accounting for a modification to a Type A lease would depend on whether lease classification changes. That is, lessors would reassess lease classification upon a modification to a Type A lease that does not result in a separate, new lease (as noted above).

The following decision tree summarizes how lessors would evaluate and account for a modification to a Type A lease under the new standard:



* Guidance for evaluating whether a modification results in a separate, new lease is discussed above.

** It is unclear how lessors would reassess classification. For example, the assessment could be made as of the original lease inception date (using modified terms) or at the effective date of the modification.

*** See lessor accounting – determining whether to defer or recognize selling profit section below.

Modification to a Type A lease that does not result in a separate, new lease — no change in lease classification

As indicated in the decision tree above, a lessor would adjust the discount rate used to measure the modified lease so that its initial net investment in the modified lease equals the carrying amount of its net investment in the original lease immediately before the effective date of the modification. No gain or loss would be recognized from such a modification, absent an impairment of the net investment in the lease (i.e., the lease receivable and any unguaranteed residual asset).

However, if the original Type A lease did not, in effect, transfer control of the underlying asset to the lessee (i.e., any initial selling profit was deferred, as discussed in the lessor accounting section), but the modified Type A lease would transfer control, a lessor would adjust the discount rate used to measure the modified lease so that its initial net investment in the modified lease would equal the carrying amount of its net investment in the original lease, exclusive of any deferred selling profit, immediately before the effective date of the modification. That is, lessors would recognize any previously deferred selling profit in income upon such a modification.

Modification of a Type A lease that does not result in a separate, new lease — change in lease classification to a Type B lease

As indicated in the decision tree above, a lessor would recognize the underlying asset at the carrying amount of its net investment in the original lease immediately before the effective date of the modification. No gain or loss would be recognized from such a modification, absent an impairment of the underlying asset.

Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

How we see it

- It is unclear whether the FASB intends to require lessors to reassess lease classification upon a modification to a Type B lease that does not result in a separate, new lease.
- It is also unclear whether the final standard would require lessees to reassess lease classification upon a modification to a Type A or a Type B lease that does not result in a separate, new lease.

Key differences between US GAAP and IFRS
The IASB decided that lessors would account for a modification to a Type A lease that does not result in a separate, new lease in accordance with IFRS 9, *Financial Instruments*. Refer to Appendix C for a summary of key differences.

Contract combinations

The new standard would require that two or more contracts entered into at or near the same time with the same counterparty (or related party) be considered a single transaction if either of the following is met:

- The contracts are negotiated as a package with a single commercial objective.
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

These criteria are intended to address the FASB's concern that separately accounting for multiple contracts may not result in a faithful representation of the combined transaction.

Portfolio approach

Many constituents had expressed concerns that the cost of applying the 2013 ED would exceed the benefits for leases involving a large number of assets that have similar characteristics (e.g., leases of a fleet of similar cars). In response, the FASB acknowledged that lessees and lessors would be able to use a portfolio approach (rather than a lease-by-lease approach) when they reasonably expect that doing so would not result in a material difference from accounting for the leases on an individual basis. The new standard would not define "reasonably expect" and "material." Instead, the FASB decided to include a discussion of the portfolio approach in the Basis for Conclusions of the new standard rather than in the text that will appear in the Codification.

Key differences between US GAAP and IFRS
The IASB decided to state explicitly in the authoritative paragraphs of its new standard that lessees and lessors also would be permitted to use a portfolio approach (rather than a lease-by-lease approach) when they reasonably expect that doing so would not result in a material difference from accounting for the leases on an individual basis. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

How we see it

The FASB's decision to discuss the portfolio approach in the Basis for Conclusions in its new standard (rather than in the text that will be codified) suggests that the approach would be applied as an accounting convention. That is, a decision to use the portfolio approach would be similar to a decision some entities make today to expense, rather than capitalize, certain assets when the accounting difference is and would continue to be immaterial to the financial statements.

Key concepts

Lessees and lessors would generally apply the same key concepts when they identify, classify, recognize and measure lease contracts, and both lessees and lessors would apply the concepts consistently.

Lease commencement and inception date

The lease commencement date would be the date on which the lessor makes an underlying asset available for use by the lessee. Lessees (except lessees applying the short-term lease exemption) and lessors (for most Type A leases) would initially recognize and measure lease-related assets and liabilities on the commencement date. Entities would consider other standards to determine how to account for and disclose the existence of other rights or obligations created between the lease inception date (i.e., the date on which the principal terms of the lease are agreed to) and the commencement date.

Lease term

Determining the lease term

The lease term would be determined at the lease commencement date based on the noncancelable term of the lease, together with both of the following:

- The periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- The periods after the exercise date of an option to terminate the lease if the lessee is reasonably certain **not** to exercise that option

The FASB decided that the phrase "reasonably certain," which is used in IAS 17 and is generally interpreted as a high threshold, has the same meaning as the phrase "reasonably assured" that is currently used in ASC 840. Therefore, the FASB does not anticipate a significant change in practice.

Purchase options would be assessed in the same way as options to extend the lease term or terminate the lease. The FASB reasoned that purchasing an underlying asset is economically similar to extending the lease term for the remaining economic life of the underlying asset. When a lease contains a purchase option and the lessee is reasonably certain to exercise that option, the lease would be classified as a Type A lease by a lessee. Lessors would be required to also evaluate an additional criterion related to the collectibility of lease payments to determine lease classification when a purchase option is present and it is reasonably certain the lessee will exercise it. See the lease classification section below.

Evaluating lease renewal, termination and purchase options

When initially evaluating the lease term and lease payments (discussed below), the new standard would require lessees and lessors to consider any factors associated with exercising lease renewal, termination and purchase options. The evaluation of whether it is reasonably certain that those options will be exercised would consider all contract-, asset-, entity- and market-based factors, including:

- The existence of a purchase option or lease renewal option and its pricing (e.g., fixed rates, discounted rates, "bargain" rates)
- The existence of a termination option and the amount of payments for termination or nonrenewal
- Contingent amounts due under residual value guarantees
- Costs of returning the asset in a contractually specified condition or to a contractually specified location
- Significant customization (e.g., leasehold improvements), installation costs or relocation costs
- The importance of the leased asset to the lessee's operations
- A sublease term that extends beyond the noncancelable period of the head lease (e.g., a head lease that has a noncancelable term of five years with a two-year renewal option, and the sublease term is for seven years)

Illustration 6 — Determining the lease term

Scenario A

Assume that Entity P enters into a lease for equipment that includes a noncancelable term of four years and a two-year market-priced renewal option. There are no termination penalties or other factors indicating that Entity P is reasonably certain to exercise the renewal option.

Analysis: At the lease commencement date, the lease term would be four years.

Scenario B

Assume that Entity Q enters into a lease for a building that includes a noncancelable term of four years and a two-year, market-priced renewal option. Before it takes possession of the building, Entity Q pays for leasehold improvements. The leasehold improvements are expected to have significant value at the end of four years, and that value can only be realized through continued occupancy of the leased property.

Analysis: At lease commencement, Entity Q determines that it is reasonably certain to exercise the renewal option because it would suffer a significant economic penalty if it abandoned the leasehold improvements at the end of the initial noncancelable period. At lease commencement, Entity Q would conclude that the lease term is six years.

Reassessment of the lease term

After lease commencement, lessees would monitor leases for significant changes that could trigger a change in the lease term. Lessees would be required to reassess the lease term upon the occurrence of significant events or significant changes in circumstances that are within the lessee's control (i.e., market-based events or changes wouldn't trigger a reassessment). The FASB expects that such events, and the related reassessment, would occur infrequently.

If the lease term changes, a lessee would remeasure the lease liability, using revised inputs (e.g., discount rate, allocation of contract consideration) at the reassessment date, and would adjust the right-of-use asset. However, if the right-of-use asset is reduced to zero, a lessee would recognize any remaining amount in profit or loss.

Lessors would not be required to reassess the lease term after lease commencement.

Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

Lease payments

Lease payments would be payments, made by a lessee to a lessor, relating to the right to use an underlying asset during the lease term. The present value of the lease payments (excluding lease incentives received by the lessee) would be recognized as a lease liability by lessees or as part of the net investment in the lease by lessors in Type A leases.

Variable lease payments that depend on an index or a rate would be included in lease payments, but other variable lease payments would not be.

Lease payments would include:

- Fixed lease payments, less any lease incentives received or receivable from the lessor
- Variable lease payments that depend on an index or a rate
- In-substance fixed lease payments structured as variable payments
- The exercise price of a purchase option if the lessee is reasonably certain to exercise that purchase option
- Payments for penalties for terminating a lease, if the lease term reflects the lessee exercising an option to terminate the lease
- Amounts expected to be payable under residual value guarantees (lessee only)
- Fixed payments structured as residual value guarantees (lessor only)

Lease payments would not include payments allocated to the non-lease components of a contract, except when the lessee makes an accounting policy election to account for the lease and non-lease components as a single lease component (as described in the identifying and separating lease from non-lease components of contracts section above).

Variable lease payments that depend on an index or rate

Variable lease payments that depend on an index or a rate would be included in the lease payments using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement). The FASB reasoned that despite the measurement uncertainty associated with changes to index- or rate-based payments, the payments meet the definition of an asset (lessor) and a liability (lessee) because they are unavoidable. These types of variable lease payments are treated differently from other contingent lease payments that do not depend on an index or rate (e.g., lease payments based on usage) because contingent lease payments that do not depend on an index or rate are generally avoidable. See the section on variable lease payments that do not depend on an index or rate below.

Under the new standard, lessees would be required to reassess variable lease payments that depend on an index or rate only when the lease liability is remeasured for other reasons (e.g., due to a change in the lease term). Otherwise, lessees would recognize changes to index- and rate-based variable lease payments in profit or loss in the period of the change (i.e., similar to other variable lease payments).

If a reassessment results in a remeasurement of the lease liability, a lessee would use revised inputs at the reassessment date and would adjust the right-of-use asset, except that:

- The amount of the remeasurement arising from a change in an index or a rate that is attributable to the current period would be recognized in profit or loss.
- If the right-of-use asset is reduced to zero, a lessee would recognize any remaining amount in profit or loss.

Lessors would not be required to reassess variable lease payments that depend on an index or rate.

Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

Key differences between US GAAP and IFRS
Under the IASB's new standard, lessees would reassess variable lease payments that depend on an index or rate when the lease liability is remeasured for other reasons (e.g., due to a change in the lease term) and upon a change in the cash flows resulting from a change in the reference index or rate (i.e., when an adjustment to the lease payments takes effect). Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

In-substance fixed lease payments structured as variable payments

Some lease agreements include payments that are described as variable but are in-substance fixed payments because the contract terms ensure that the payment of a fixed amount is unavoidable. Such payments would be included in the lease payments at lease commencement and thus used to measure entities' lease assets and lease liabilities.

The exercise price of a purchase option

Entities would consider the exercise price of asset purchase options included in lease contracts consistently with the evaluation of lease renewal and termination options (discussed above). That is, if the lessee is reasonably certain to exercise a purchase option, the exercise price would be included as a lease payment.

Payments for penalties for terminating a lease

The determination of whether to include lease termination penalties as lease payments would be similar to the evaluation of lease renewal options. If it is reasonably certain that the lessee will not terminate a lease, the lease term would be determined assuming that the termination option would not be exercised, and any termination penalty would be excluded from the lease payments. Otherwise, the lease termination penalty would be included as a lease payment.

Amounts expected to be payable under residual value guarantees — lessees only

The new standard would require lessees to include the amounts they expect to pay to the lessor under residual value guarantees as lease payments.

A lessee may provide a guarantee to the lessor that the value of the underlying asset it returns to the lessor at the end of the lease will be at least a specified amount. Such guarantees represent enforceable obligations that the lessee has assumed by entering into the lease. Uncertainty related to a lessee's guarantee of a lessor's residual value affects the measurement of the obligation rather than the existence of an obligation.

Illustration 7 — Residual value guarantee included in lease payments

Entity R (lessee) enters into a lease and guarantees that the lessor will realize $15,000 from selling the asset to another party at the end of the lease. At lease commencement, Entity P estimates that the underlying asset will have a value of $9,000 at the end of the lease.

Analysis: Entity R expects to pay the lessor $6,000 under the residual value guarantee and would include that amount as a lease payment.

How we see it

We expect the FASB to include in the final standard a provision of the 2013 ED that would require the remeasurement of a lessee's lease liability and adjustment of the right-of-use asset if the amounts expected to be payable under residual value guarantees change during the lease term. If the right-of-use asset is reduced to zero, the provision would require the remaining adjustment to be recognized in profit or loss. The FASB did not discuss this provision in redeliberations.

The residual value guarantee reassessment provision would not apply to lessors.

Residual value guarantees — lessors only

Lessors' lease payments would generally exclude amounts receivable under residual value guarantees (from either the lessee or a third party). However, fixed lease payments structured as residual value guarantees (typically from the lessee but possibly from another party) would be included as lease payments.

For example, assume a lessor obtains a guarantee for the entire residual value of the underlying asset from the lessee, also the contract states that the lessor will pay to the lessee, or the lessee can retain, any difference between the selling price of the underlying asset and the residual value guarantee specified in the contract. In these cases, the lessee is exposed to all of the upside and downside risk of changes in the value of the asset, and the lessor would receive a fixed amount (i.e., the guarantee specified in the contract) at the end of the lease. The amount the lessor would receive is economically similar to a fixed balloon lease payment at the end of the lease. Consequently, such amounts would be included as lease payments.

Variable lease payments that do not depend on an index or rate

Variable payments that do not depend on an index or rate, such as those based on performance (e.g., a percentage of sales) or usage of the underlying asset (e.g., the number of hours flown, the number of units produced), would not be included as lease payments. These payments would be recognized in profit or loss when they are incurred (lessee) or earned (lessor), in a manner similar to today's accounting. For example, a variable payment based on the annual sales of a leased store would not be included in the lessee's right-of-use asset or lease liability. Instead, the variable payment would be recognized as an expense (by the lessee) and as income (by the lessor) as the sales at the store occur and an obligation for the lessee to make the contingent payment is created.

Discount rate

Discount rates would be used to determine the present value of the lease payments, which are used to determine lease classification (refer to the lease classification section below) and to measure a lessor's recognized net investment in the lease and the lessee's lease liability. Under the new standard, the rate the lessor charges the lessee would be defined as "the rate implicit in the lease." The rate implicit in the lease would reflect the nature and specific terms of the lease and would be similar to the current definition in US GAAP.

Lessors

Lessors would use the rate implicit in the lease that causes the sum of the following two items:

- The present value of lease payments made by the lessee for the right to use the underlying asset
- The present value of the amount the lessor expects to derive from the underlying asset at the end of the lease (excluding any amount included in lease payments)

To equal the sum of these two items:

- The fair value of the underlying asset
- The lessor's initial direct costs (in the case of Type A leases without recognized selling profit)

A lessor's initial direct costs for Type A leases with recognized selling profit would be expensed at lease commencement, and therefore, would be excluded from the calculation of the rate implicit in the lease for those leases. See the lessor accounting section below.

How we see it

The FASB's decision to define the discount rate as the "rate implicit in the lease" would result in two key changes in practice for lessors. The calculation of the rate implicit in the lease would include the lessor's initial direct costs for Type A leases without recognized selling profit and would exclude investment tax credits that the lessor retains and expects to realize.

Lessees

Lessees would also use the rate implicit in the lease as described above if that rate can be readily determined. When the lessee cannot determine that rate, the lessee would use its incremental borrowing rate. The lessee's incremental borrowing rate would be the rate of interest that the lessee would have to pay to borrow the funds necessary to obtain an asset of a similar value to the right-of-use asset, with similar payment terms (i.e., consistent with the lease term) and security (i.e., collateral) in a similar economic environment. This definition would be generally consistent with the definition in ASC 840.

Under the new standard, lessees that are not public business entities (PBEs)[5] would be permitted to make an accounting policy election to use the risk-free rate for the initial and subsequent measurement of lease liabilities. The risk-free rate would be determined using a period comparable with the lease term. The accounting policy election would be applied to all leases and disclosed in the notes to the financial statements.

Key differences between US GAAP and IFRS

The IASB's new standard would not provide an accounting policy election for lessees to use the risk-free rate for the initial and subsequent measurement of lease liabilities.

Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

How we see it

- The rate implicit in the lease would not necessarily be the rate stated in the contract and could reflect the lessor's initial direct costs and estimates of residual value. Therefore, lessees may find it difficult to determine the rate implicit in the lease.
- While using a risk-free rate might reduce complexity for lessees applying the new standard, it would increase the likelihood that the present value of the lease payments and any residual value guaranteed by the lessee would amount to substantially all of the fair value of the leased asset, potentially resulting in a Type A lease. This might dissuade some non-PBE lessees from making a policy election to use a risk-free rate.

Reassessment of the discount rate (updated July 2015)

Lessees would reassess the discount rate only upon a lease modification, a change to the lease term or a change in whether the lessee is reasonably certain to exercise an option to purchase the underlying asset.

If a reassessment results in a change to the discount rate, lessees would remeasure the lease liability using a revised discount rate at the reassessment date and would adjust the right-of-use asset. However, if the right-of-use asset is reduced to zero, a lessee would recognize any remaining amount in profit or loss.

Lessors would be required to reassess the discount rate upon a contract modification to a Type A lease that does not result in a separate, new lease when the modified lease remains a Type A lease (i.e., when lease classification does not change).

Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

Key differences between US GAAP and IFRS

Under the IASB's new standard, lessors would not be required to reassess the discount rate after lease commencement.

Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Initial direct costs

Initial direct costs would be costs such as commissions that would not have been incurred if a lease had not been executed. Lessees and lessors would apply the same definition of initial direct costs. From the lessor's perspective, initial direct costs would be consistent with the concept of incremental costs in the new revenue recognition standard (i.e., ASC 606).

The new lease standard would require lessors to include initial direct costs in the initial measurement of their net investments in Type A leases. However, initial direct costs related to Type A leases that include recognized selling profit would be expensed at lease commencement. Lessors would recognize initial direct costs associated with Type B leases over the lease term on the same basis as lease income.

The new lease standard would require lessees to include their initial direct costs in their initial measurement of the right–of-use asset. Costs that a lessee incurs in a lease modification that meet the definition of initial direct costs would be included in the measurement of the new right-of-use asset (i.e., for a modification that results in a separate, new lease) or the adjustment to the right-of-use asset (i.e., for a modification that does not result in a separate, new lease).

How we see it

The FASB's clarification that only costs that wouldn't be incurred if a lease hadn't been executed would qualify as initial direct costs would result in two key changes in practice. Lessors' initial direct costs would exclude allocated costs (e.g., salaries) and costs incurred before the lease is executed (e.g., legal advice).

Economic life

The new standard would define the economic life of an asset as either:

- The period over which an asset is expected to be economically usable by one or more users
- The number of production or similar units expected to be obtained from the asset by one or more users

This definition of economic life, while not the same as the definition in current US GAAP, is not expected to significantly change economic life estimates.

Fair value of the underlying asset

Under today's accounting, the fair value of leased property is defined as the price for which the property could be sold in an arm's length transaction between unrelated parties. ASC 820, *Fair Value Measurement*, which provides a framework for measuring fair value, defines fair value within that framework and establishes fair value measurement disclosure requirements. Importantly, the definition of fair value in ASC 820 does not apply to fair value measurements for the purposes of lease classification and measurement (with certain exceptions). That is, the fair value of leased property, which is used in classifying a lease and to determine the maximum amount at which a lessee can record an asset leased under a capital lease, is not a fair value measurement under the framework set out in the current US GAAP guidance.

How we see it

- The 2013 ED did not define fair value of the underlying asset or propose consequential amendments to ASC 820 to remove the scope exception for leases. Because the FASB did not address this topic in redeliberations, we do not anticipate the Board will change the meaning of fair value in the context of leased assets in the new standard.
- It is unclear whether the new standard will contain a "fair value constraint" that would set a maximum amount that could be used when recording a right-of-use asset.

Key differences between US GAAP and IFRS

As discussed above, the definition of fair value in ASC 820 would not apply to fair value measurements for the purposes of lease classification and measurement under the FASB's new standard. However, the measurement and disclosure requirements of IFRS 13, *Fair Value Measurement*, would apply to lease transactions within the scope of the IASB's new standard.

Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Related party leasing transactions

The new standard would require lessees and lessors to account for related party leases on the basis of the legally enforceable terms and conditions of the lease. This would eliminate the current requirement under US GAAP for lessees and lessors to evaluate the economic substance of a lease to determine the appropriate accounting. Under the new standard, lessees and lessors would still be required to apply the disclosure requirements for related party transactions in accordance with ASC 850, *Related Party Disclosures*.

Key differences between US GAAP and IFRS
The IASB's new standard would not have guidance on the accounting for related party leasing transactions. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Lease classification (updated July 2015)

Under the new standard, lessees and lessors would classify all leases (with an optional exemption for short-term leases for lessees) using a principle similar to that of IAS 17. The principle in IAS 17 is similar to that of US GAAP but without today's bright lines. The new standard would eliminate ASC 840's real estate-specific guidance and would change its additional lessor classification criteria.

Lessees and lessors would classify leases using a principle similar to the one in IAS 17.

The new standard would require lessees to classify most leases as either Type A leases (generally today's capital leases) or Type B leases (generally today's operating leases). Lease classification would determine how and when a lessee would recognize lease expense.

Lessors would be required to classify all leases as either Type A leases or Type B leases (generally today's operating leases). There would be three categories of Type A leases: (1) those with selling profit that is recognized or deferred (generally today's sales-type leases), (2) those with no selling profit (generally today's direct financing leases), and (3) certain leases where collectibility of lease payments is not probable. Leases in the latter category would be recognized and measured in accordance with ASC 606 (i.e., a deferral of income similar to the new revenue standard). Refer to the lessor accounting section below for discussion of the recognition and measurement of lessors' leases.

Criteria for classification of leases (lessees and lessors)

At lease commencement, a lessee and a lessor would evaluate whether a lease meets any of the following criteria for purposes of lease classification: [6]

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lessee is reasonably certain to exercise an option to purchase the underlying asset.
- The lease otherwise transfers substantially all the risks and rewards incidental to ownership of the underlying asset. Situations that individually or in combination would normally indicate this include:
    - The lease term is for a major part of the remaining economic life of the underlying asset.

- *For lessors* — The sum of the present value of the lease payments and any residual value guaranteed by any third party unrelated to the lessor (including the lessee) amounts to substantially all of the fair value of the underlying asset at lease commencement.
- *For lessees* — The sum of the present value of the lease payments and any residual value guaranteed by the lessee amounts to substantially all of the fair value of the underlying asset at lease commencement.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

A lease would be classified as a Type A lease by lessees if it meets any one of the criteria above. At its May 2015 meeting, the FASB decided that for leases that meet any of the above criteria, a lessor would also consider whether the collectibility of lease payments is probable for purposes of lease classification.

If a lease does not meet any of the criteria above, it would be classified as a Type B lease by lessees and lessors.

Additional lessor classification criterion

Under the new standard, lessors would also be required to evaluate the collectibility of lease payments to determine lease classification. This assessment would also affect a lessor's recognition and measurement of its leases. Refer to the lessor accounting section below.

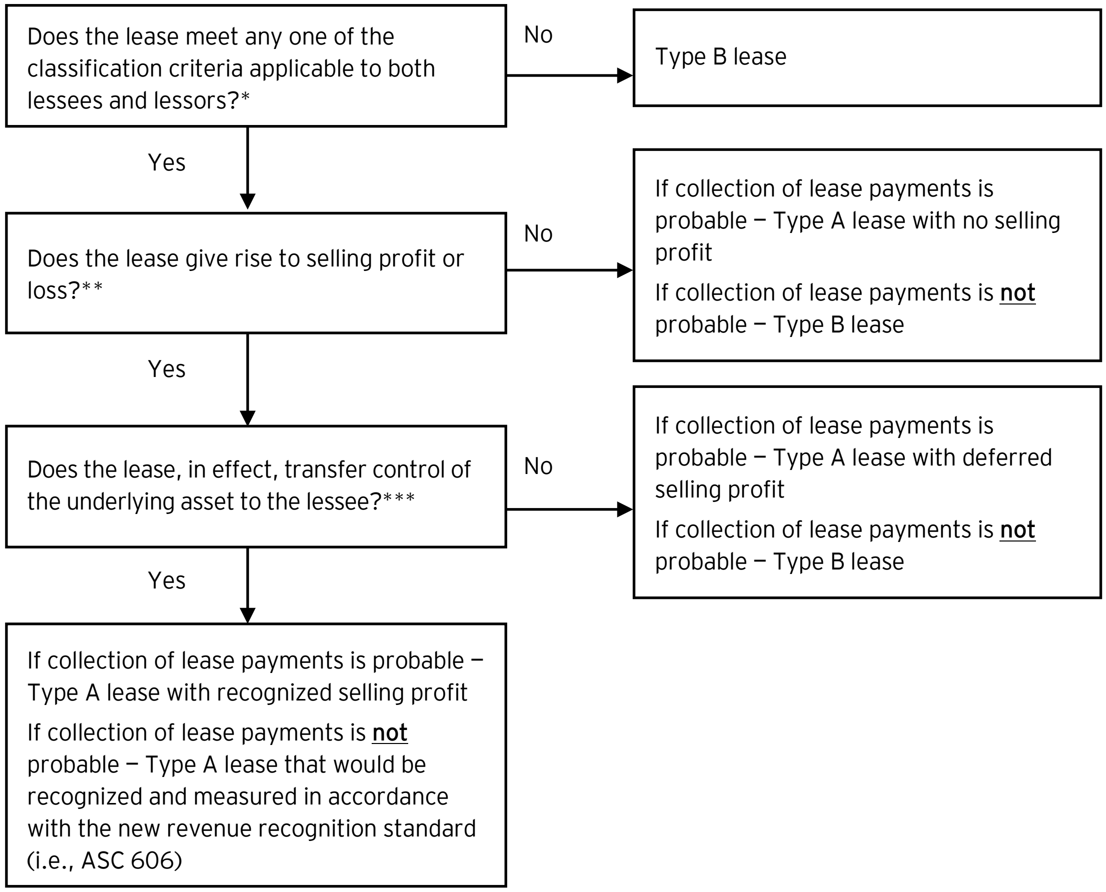
How we see it

Although the new standard's classification principle and criteria would be similar to that in IAS 17 today, there are three notable differences:

- The presence of any one of the IAS 17 classification indicators is not necessarily determinative of lease classification under IFRS today. However, it appears that the presence of any one of the new standard's classification criteria (described above) would result in a lease being classified as Type A for lessees and lessors (subject to the additional lessor collectibility criterion).
- Some of the classification indicators in IAS 17 today were not discussed in redeliberations or included in the new standard's criteria described above (e.g., a lessee's ability to continue the lease for a secondary period at a rent that is substantially lower than market rent, although this criterion may affect lease term and indirectly lease classification under the new standard).
- IAS 17 doesn't explicitly require lessors to assess the collectibility of lease payments for purposes of lease classification.

As a result, we believe the Board could further align the classification criteria with IAS 17 in the final standard.

The decision tree below summarizes the evaluation of lease classification for lessors, including the recognition and measurement alternatives for Type A leases, under the new standard. Note — the FASB could further clarify its decisions on lease classification, recognition and measurement for lessors in the final standard.



* See the criteria for classification of leases (lessees and lessors) section above.

** See the lessor accounting — selling profit or loss section below.

*** See the lessor accounting — determining whether to defer or recognize selling profit section below.

Other lease classification matters

Evaluating 'major part' and 'substantially all'

The terms "major part" and "substantially all" were not defined in the 2013 ED or during redeliberations. However, these terms are used to describe the indicators included today under IFRS to distinguish between finance and operating leases and were introduced into IFRS by borrowing from the bright-line tests used for lease classification in US GAAP.

Residual value guarantees included in the lease classification test

In evaluating the new standard's lease classification criteria, lessees would be required to include in the "substantially all" test the full amounts of residual value guarantees they provide. Lessors would be required to include in this test the full amounts of residual value guarantees provided by unrelated third parties, including the lessee.

Residual value guarantees would be treated differently when determining lease payments. Lessees would include amounts they expect to pay to lessors under residual value guarantees as lease payments. Lessors' lease payments receivable would generally exclude amounts under residual value guarantees (from either the lessee or a third party) unless the residual value guarantee is in-substance a fixed lease payment. Refer to the lease payments section above.

Lease component with the right to use more than one interrelated asset

If a lease component contains the right to use more than one interrelated asset, the primary asset in the component would be used to determine lease classification. The primary asset would be the predominant asset for which the lessee has contracted the right to use. Any other assets in that lease component would facilitate the lessee's use of the primary asset. Entities would also refer to the economic life of the primary asset when making lease classification assessments.

Reassessment of lease classification

At its May 2015 meeting, the FASB decided that lessors would reassess lease classification upon a modification to a Type A lease that does not result in a separate, new lease. Refer to the lease modifications section above.

If a modification to a contract results in a separate, new lease, that new lease would be classified using the criteria described above.

Refer to Appendix A for a summary of lessee and lessor reassessment requirements.

The Boards reached different conclusions on lease classification for lessees and lessors.

How we see it

- It is unclear how lessors would reassess lease classification upon a modification to a Type A lease that does not result in a separate, new lease. For example, the assessment could be made as of the original lease inception date (using the modified terms) or at the effective date of the modification. It is also unclear whether the FASB intends to require lessors to reassess lease classification upon a modification to a Type B lease that does not result in a separate, new lease.
- In addition, it is unclear whether the final standard would require lessees to reassess lease classification upon a modification to a Type A or a Type B lease that does not result in a separate, new lease.

Key differences between US GAAP and IFRS

The Boards reached different decisions that would result is similar transactions being accounted for differently under US GAAP and IFRS.

Lessees

Lessees applying the FASB's new standard would use a dual model to recognize and measure leases with an option not to recognize and measure short-term leases. However, lessees applying the IASB's new standard would use a single recognition and measurement model for all leases (i.e., all leases would be Type A), with options not to recognize and measure both short-term leases and leases of small assets.

The FASB members who favored the dual model indicated that the FASB's new standard would be less costly for preparers to apply and for users to understand because it would use a lease classification principle similar to the one in ASC 840. The IASB members who favored the single model indicated that it is more conceptually sound because they believe that all leases contain a financing element. However, in lieu of the dual model, they did incorporate a small asset exemption. Some IASB members also indicated that the single model would be less costly to apply because preparers would not have to consider a classification test.

Lessors
Both new standards would use a dual model for all leases (i.e., all leases would be Type A or Type B). However, under the FASB's new standard, lessors would consider an additional criterion based on the collectibility of lease payments to classify leases.

Reassessment of lease classification
Lessors applying the FASB's new standard would reassess lease classification upon a modification to a Type A lease that does not result in a separate, new lease. Under the IASB's new standard, lease classification would not be reassessed after lease commencement for any lease.

Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Lessee accounting

The new standard would require lessees to recognize all leases on the balance sheet, except for short-term leases if they choose to apply that exemption. At the commencement date of a lease, a lessee would recognize a liability to make lease payments (i.e., the lease liability) and an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset).

The initial recognition of the right-of-use asset and the lease liability would be the same for Type A and Type B leases, as would the subsequent measurement of the lease liability. However, the subsequent measurement of the right-of-use asset for Type A and Type B leases would differ.

Initial recognition and measurement

The lease liability would be initially measured based on the present value of the lease payments to be made over the lease term. Lessees would apply the concepts described above to identify the lease components and to determine the lease term, lease payments and discount rate as of the commencement date of the lease. See the key concepts section above.

The right-of-use asset would initially be measured at cost and would consist of all of the following:

- The amount of the initial measurement of the lease liability
- Any lease payments made to the lessor at or before the commencement date, less any lease incentives received from the lessor (see the section on other lessee matters below)
- Any initial direct costs incurred by the lessee (see the section on initial direct costs above)

Subsequent measurement

Lease liabilities — Type A leases

The FASB believes that a lease liability for Type A leases should be accounted for in a manner similar to other financial liabilities (i.e., on an amortized cost basis). Consequently, the lease liability for Type A leases would be accreted using an amount that produces a constant periodic discount rate on the remaining balance of the liability (i.e., the discount rate determined at commencement, as long as a reassessment and a change in the discount rate have not been triggered). Lease payments would reduce the lease liability when paid.

Right-of-use assets — Type A leases

Amortization of the right-of-use asset would be recognized in a manner consistent with existing standards for nonfinancial assets that are measured at cost. Lessees would amortize the right-of-use asset on a straight-line basis, unless another systematic basis better represents the pattern in which the lessee expects to consume the right-of-use asset's future economic benefits. The right-of-use asset would generally be amortized over the shorter of the lease term or the useful life of the right-of-use asset. The amortization period would be the remaining useful life of the underlying asset if the lessee is reasonably certain to exercise a purchase option or if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

Illustration 8 — Lessee accounting for a Type A lease

Entity H (lessee) enters into a three-year lease of equipment and concludes that the agreement is a Type A lease because the lease term is for a major part of the remaining economic life of the underlying asset (also three years). Entity H agrees to make the following annual payments at the end of each year: $10,000 in year one, $12,000 in year two and $14,000 in year three. For simplicity, there are no other elements to the lease payments (e.g., purchase options), payments to the lessor before the lease commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is $33,000 (present value of lease payments using a discount rate of approximately 4.235%). Entity H uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Entity H determines the right-of-use asset should be amortized on a straight-line basis over the lease term.

Analysis: At lease commencement, Entity H would recognize the lease-related asset and liability:

Right-of-use asset	$ 33,000	
Lease liability		$ 33,000

To initially recognize the lease-related asset and liability

The following journal entries would be recorded in the first year:

Interest expense	$ 1,398	
Lease liability		$ 1,398

To record interest expense and accrete the lease liability using the interest method ($33,000 x 4.235%)

Amortization expense	$ 11,000	
Right-of-use asset		$ 11,000

To record amortization expense on the right-of-use asset ($33,000 ÷ 3 years)

Lease liability	$ 10,000	
Cash		$ 10,000

To record lease payment

A summary of the lease contract's accounting (assuming no changes due to reassessment) is as follows:

	Initial	Year 1	Year 2	Year 3
Cash lease payments		$ 10,000	$ 12,000	$ 14,000
Lease expense recognized				
Interest expense		$ 1,398	$ 1,033	$ 569
Amortization expense		11,000	11,000	11,000
Total periodic expense		$ 12,398	$ 12,033	$ 11,569
Balance sheet				
Right-of-use asset	$ 33,000	$ 22,000	$ 11,000	$ –
Lease liability	$ (33,000)	$ (24,398)	$ (13,431)	$ –

The total periodic expense (i.e., the sum of interest and amortization expense) of a Type A lease would generally be higher in the early periods and lower in the later periods. Because a consistent interest rate would be applied to the lease liability, which decreases as cash payments are made during the lease term, more interest expense would be incurred in the early periods and less would be incurred in the later periods. This trend in the interest expense, combined with the straight-line amortization of the right-of-use asset, would generally result in a front-loaded expense recognition pattern for Type A leases, which is consistent with the subsequent measurement of capital leases under ASC 840.

The separate recognition of interest and amortization expense for Type A leases is consistent with a view that such leases are effectively installment purchases. That is, the lessee is paying to finance the acquisition of the underlying asset that will be consumed during the lease term.

Lease liabilities — Type B leases

Lessees would calculate the lease liability for Type B leases at any point in time as the present value of the remaining lease payments using the discount rate determined at lease commencement, as long as a reassessment and a change in the discount rate hasn't been triggered.

How we see it

While we expect the new standard to describe the subsequent measurement of a Type B lease liability differently from that of a Type A lease liability, from a practical perspective, we expect the result of the subsequent measurement to be the same.

Right-of-use assets — Type B leases

Lessees would subsequently measure the right-of-use asset (absent any impairment) for a Type B lease at the amount of the remeasured lease liability (i.e., the present value of the remaining lease payments), adjusted for any lease incentives received, any cumulative prepaid or accrued rent if the lease payments are uneven throughout the lease term and any lessee initial direct costs. The presence of uneven lease payments or lessee initial direct costs would cause the measurement of the right-of-use asset to differ from that of the lease liability at points throughout the lease term.

Lessees would recognize periodic lease expense for Type B leases on a straight-line basis, similar to today's accounting for operating leases. Throughout the lease term, the lessee would recognize periodic lease expense as ***the greater of*** the following:

(1) The remaining cost of the lease (calculated at the beginning of each period) allocated over the remaining lease term on a straight-line basis, or

(2) The periodic accretion on the lease liability (i.e., the difference between (a) the lease liability at the beginning of the period less payments made during the period and (b) the lease liability at the end of the period)

The remaining cost of the lease (item (1) above) would be calculated as:

- Lease payments (determined at the lease commencement date)
- Plus lessee initial direct costs (determined at the lease commencement date)
- Minus the periodic lease cost recognized in prior periods
- Minus any impairment of the right-of-use asset recognized in prior periods
- Plus or minus any adjustments to reflect changes that arise from the remeasurement of the lease liability not recognized in profit or loss at the date of remeasurement (e.g., the present value of the additional lease payments a lessee is obligated to pay if it exercises a renewal option that it originally was not reasonably certain to exercise)

The periodic accretion on the lease liability might be higher than the remaining cost of the lease allocated over the remaining lease term in the case of a significant impairment of the right-of-use asset.

Illustration 9 — Lessee accounting for a Type B lease

Entity L (lessee) enters into a three-year lease of office space and concludes that the agreement is a Type B lease. Entity L agrees to pay the following annual payments at the end of each year: $10,000 in year one, $12,000 in year two and $14,000 in year three. For simplicity, there are no other elements to the lease payments (e.g., purchase options), payments to the lessor before the lease commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is $33,000 using a discount rate of approximately 4.235%. Entity L uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Entity L calculates that the annual straight-line lease expense is $12,000 per year [($10,000 + $12,000 + $14,000) ÷ 3].

Analysis: At lease commencement Entity L would recognize the lease-related asset and liability:

Right-of-use asset	$ 33,000	
Lease liability		$ 33,000

To initially recognize the lease-related asset and liability

The following journal entries would be recorded in the first year:

Lease expense	$ 12,000	
Right-of-use asset		$ 2,000
Cash		$ 10,000
Lease liability	$ 8,602	
Right-of-use asset		$ 8,602

To record lease expense and adjust the right-of-use asset for the difference between cash paid and straight-line lease expense (i.e., accrued rent). To adjust the lease liability to the present value of the remaining lease payments with an offset to the right-of-use asset. The adjustment of $8,602 is calculated as the initially recognized lease liability ($33,000) less the present value of remaining lease payments ($24,398) at the end of Year 1.

A summary of the lease contract's accounting (assuming no changes due to reassessment) is as follows:

	Initial	Year 1	Year 2	Year 3
Cash lease payments:		$ 10,000	$ 12,000	$ 14,000
Income statement:				
Periodic lease expense (straight-line)		12,000	12,000	12,000
Prepaid (accrued) rent for period		$ (2,000)	$ –	$ 2,000
Balance sheet:				
Lease liability	$ (33,000)	$ (24,398)	$ (13,431)	$ –
Right-of-use asset				
Lease liability	$ 33,000	$ 24,398	$ 13,431	$ –
Adjust: prepaid/(accrued) rent (cumulative)	–	(2,000)	(2,000)	–
Right-of-use asset	$ 33,000	$ 22,398	$ 11,431	$ –

Lease expense would be presented in a single line item in the income statement. This presentation is consistent with the concept of the lessee paying to use the asset during the lease term, rather than paying to finance the acquisition of the underlying asset in a Type A lease.

Illustration 10 — Comparing the two types of leases for lessees

This table illustrates the similarities and differences in accounting for the two types of leases discussed in Illustrations 8 and 9:

Type A lease:

Time	Lease liability	ROU asset	Interest expense	Amortization expense	Total expense
Initial	$ 33,000	$ 33,000			
Year 1	$ 24,398	$ 22,000	$ 1,398	$ 11,000	$ 12,398
Year 2	$ 13,431	$ 11,000	1,033	11,000	12,033
Year 3	$ –	$ –	569	11,000	11,569
			$ 3,000	$ 33,000	$ 36,000

Type B lease:

Time	Lease liability	Cumulative prepaid or (accrued) rent[1]	ROU asset	Lease expense
Initial	$ 33,000	$ –	$ 33,000	
Year 1	$ 24,398	$ (2,000)	$ 22,398	$ 12,000
Year 2	$ 13,431	$ (2,000)	$ 11,431	12,000
Year 3	$ –	$ –	$ –	12,000
				$ 36,000

[1] Prepaid and accrued rent amounts would not be presented separately on the balance sheet. Instead, the ROU asset would be presented on the balance sheet net of cumulative prepaid or accrued amounts (if any).

The initial measurement of the right-of-use asset and the lease liability would be the same for Type A and Type B leases. Also, the same total lease expense would be recognized over the life of the arrangement. However, a lessee would generally recognize higher periodic lease expense in the earlier periods of a Type A lease than it would for a Type B lease.

Type A leases would generally have a front-loaded expense recognition pattern.

Changes in foreign currency exchange rates

Lessees would apply ASC 830, *Foreign Currency Matters*, to leases denominated in a foreign currency. Lessees would remeasure the foreign currency-denominated lease liability using the exchange rate at each reporting date. Any changes to the lease liability due to exchange rate changes would be recognized in profit or loss. Because the right-of-use asset is a nonmonetary asset measured at historical cost, it would not be affected by changes in the exchange rate.

Other lessee matters

Impairment

Lessees' right-of-use assets, for both types of leases, would be subject to existing impairment guidance in ASC 360, *Property, Plant, and Equipment*.

ASC 360 requires an analysis of impairment indicators at each reporting period. If any indicators are present, a recoverability test using undiscounted cash flows is performed. If the recoverability test fails, the standard requires a fair value test. Under the new leases standard, if an impairment loss is recognized, the adjusted carrying amount of a right-of-use asset would be its new accounting basis. Consistent with ASC 360, the impairment test for right-of-use assets often would be performed at an asset-group level. The subsequent reversal of an impairment loss for an asset held for use would be prohibited.

How we see it

While lessees would apply existing impairment guidance in the same manner they currently do for assets held under capital leases (generally would be Type A leases), the analysis would be new for current operating leases (generally would be Type B leases). For leases that are not currently on the balance sheet, the requirement to test right-of-use assets for impairment could accelerate expense recognition (i.e., if an impairment occurs).

Lease incentives received or receivable at lease commencement

Lessees often receive incentives (e.g., an up-front cash payment for leasehold improvements or relocation expenses) for entering into a new lease. Today's operating lease accounting requires lessees to recognize lease incentives over the lease term as a reduction of lease expense.

Under the new standard, lease incentives that are receivable from the lessor at the commencement date (i.e., amounts are paid by the lessor after the lease commencement date) would be deducted from lease payments and the corresponding lease liability and right-of-use asset. Separately, lease incentives that a lessee receives from the lessor at or before lease commencement would reduce the initial measurement of the right-of-use asset. Similar to the result under current operating lease accounting, lease incentives would reduce lease expense for both types of leases over the lease term.

Lease incentives not received or receivable at lease commencement

The 2013 ED did not address lease incentives that are contingently receivable by the lessee at the lease commencement date (i.e., lease incentives that are not received or receivable until the occurrence of an event subsequent to lease commencement) nor were such incentives discussed during redeliberations. Examples include reimbursements for moving costs or leasehold improvements that become receivable by the lessee when the lessee incurs these costs.

How we see it

It remains unclear whether and, if so, how incentives that are not received or receivable at lease commencement would be considered in the recognition and measurement of lessees' lease-related assets and liabilities.

Purchase of a leased asset by the lessee during the lease term (updated July 2015)

The new standard would include ASC 840's existing guidance for the purchase of a leased asset by a lessee during the term of a capital lease for both Type A and Type B leases. A lessee would account for the purchase of the leased asset and the related lease termination as a single transaction. The difference between the purchase price and the carrying amount of the lease liability would be recorded as an adjustment to the carrying amount of the asset. No gain or loss would be recognized.

Key differences between US GAAP and IFRS
The IASB did not discuss a lessee's accounting for the purchase of a leased asset during the lease term. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Income tax accounting

The new standard would also affect lessees' accounting for income taxes. For lessees, the new standard would change the measurements of lease-related assets and liabilities, including the recognition of amounts that are not on the balance sheet today (i.e., amounts related to leases that are operating leases today), and the expense recognition pattern. These changes would affect many aspects of accounting for income taxes such as the following:

- Recognition and measurement of deferred tax assets and liabilities
- Assessment of the recoverability of deferred tax assets (i.e., the need for and measurement of a valuation allowance)

Presentation

While the new standard would change balance sheet presentation for lessees, the income statement and statement of cash flows presentation requirements for Type A leases and Type B leases would be similar to the current requirements for capital and operating leases, respectively.

The following table summarizes how lease-related amounts and activities would be presented in lessees' financial statements.

<table>
<tr><th>Financial statement</th><th>Lessee presentation</th></tr>
<tr><td>Balance sheet</td><td>Type A leases:
Right-of-use assets presented either:
Separately from other assets (e.g., owned assets)
Together with the corresponding underlying assets as if they were owned, with disclosures of the balance sheet line items that include Type A right-of-use assets and their amounts
Lease liabilities presented either:
Separately from other liabilities
Together with other liabilities with disclosure of the balance sheet line items that include Type A lease liabilities and their amounts
Type B leases:
Right-of-use assets presented separately from Type A right-of-use assets with disclosure of the related balance sheet line items that include the Type B assets
Lease liabilities presented separately from Type A lease liabilities
The FASB decided not to otherwise specify how lessees would separately present Type B right-of-use assets and lease liabilities except to say the presentation should be rational and consistent with similar leases and appropriate based on the facts and circumstances</td></tr>
<tr><td>Income statement</td><td>Type A leases: Lease-related amortization and lease-related interest expense would be presented separately (i.e., lease-related amortization and interest expense could not be combined)
Type B leases: Lease-related expenses would be presented as a single line of lease or rent expense</td></tr>
</table>

Financial statement	Lessee presentation
Statement of cash flows	‣ **Type A leases:** Cash payments for the principal portion of the lease liability would be presented within financing activities and cash payments for the interest portion would be presented within operating activities in accordance with ASC 230, *Statement of Cash Flows* ‣ **Type B leases:** Cash payments for lease payments would be presented within operating activities ‣ **Both types of leases:** ‣ Lease payments for short-term leases not recognized on the balance sheet and variable lease payments (not included in the lease liability) would be presented within operating activities ‣ Noncash activity (e.g., the initial recognition of the lease at commencement) would be disclosed as a supplemental noncash item

Key differences between US GAAP and IFRS

Under the IASB's new standard, cash paid for interest on Type A leases would be presented within operating or financing activities consistent with the entity's policy election under IAS 7, *Statement of Cash Flows*.

Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Disclosure

The objective of lessee disclosures would be to enable financial statement users to assess the amount, timing and uncertainty of cash flows arising from leases. Lessees would exercise judgment to determine the appropriate level at which to aggregate, or disaggregate, disclosures so that meaningful information will not be obscured by insignificant details or by groupings of items with different characteristics. The disclosure requirements would apply to both public and nonpublic business entities.

Qualitative disclosures

Lessees would be required to disclose the following qualitative information:

- The nature of their leases (and subleases, as applicable), including:
  - A general description of those leases
  - The basis, and terms and conditions, on which variable lease payments are determined
  - The existence, and terms and conditions, of options to extend or terminate the lease (including descriptions of the options that are recognized as part of the right-of-use assets and lease liabilities and those that are not)
  - The existence, and terms and conditions, of lessee residual value guarantees
  - The restrictions or covenants imposed by leases (e.g., those related to dividends or incurring additional financial obligations)
- Information about leases that have not yet commenced but that create significant rights and obligations for the lessee

- Information about the significant judgments and assumptions made in accounting for leases, which might include:
  - The determination of whether a contract contains a lease
  - The allocation of contract consideration between lease and non-lease components
  - The determination of the discount rate
- The main terms and conditions of any sale and leaseback transactions
- Whether an accounting policy election was made for the short-term lease exemption

Lessees would be required to provide these qualitative disclosures in sufficient detail such that the lessee disclosure objective is met.

Quantitative disclosures

Lessees would be required to disclose the following quantitative information:

- Type A lease expense (with amortization of right-of-use assets disclosed separately from interest on lease liabilities)
- Type B lease expense
- Short-term lease expense for such leases with a lease term greater than one month
- Variable lease expense
- Sublease income
- Cash paid for amounts included in the measurement of lease liabilities separately by lease type (i.e., Type A , Type B) and segregated between operating and financing cash flows
- Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets (e.g., for new leases) separately by lease type
- Weighted-average remaining lease term, separately by lease type
- Weighted-average discount rate as of the reporting date, separately by lease type
- Gains and losses arising from sale and leaseback transactions

The new standard would expand lessees' disclosures to include judgments made and assumptions used to account for leases.

Expense items disclosed would also include any amounts capitalized as part of the cost of another asset.

The new standard would not require a specific format for lessees' quantitative disclosures, but would include an example presenting quantitative disclosures in a tabular format.

Lessees would also be required to disclose a maturity analysis of lease liabilities. The maturity analysis would include undiscounted cash flows, on an annual basis, for a minimum of each of the five years after the balance sheet date and a total of the amounts for the remaining years (i.e., the total undiscounted cash flows beyond the fifth year). The analysis would also include a reconciliation of the undiscounted cash flows to the lease liabilities presented on the balance sheet.

Key differences between US GAAP and IFRS
The IASB's new standard would not require specific qualitative disclosures. Instead, lessees would be required to disclose qualitative information necessary to satisfy the lessee disclosure objective. The FASB and the IASB differ on specific lessee quantitative disclosure requirements mainly because of differences in the lessee accounting models. For example, the FASB's new standard would require the disclosure of Type B lease expense, which is not applicable under the IASB's new standard (under which all lessee leases would be Type A). In addition, the FASB would not require a specific format for lessee quantitative disclosures. However, the IASB would require the disclosure to be made in a tabular format unless another format is more appropriate. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Lessor accounting (updated July 2015)

As discussed in the lease classification section, lessors would classify all leases as Type A or Type B. There would be three categories of Type A leases, which would affect how those leases are recognized and measured:

- Type A leases with selling profit that is recognized or deferred (similar to ASC 840's sales-type leases)
- Type A leases with no selling profit (similar to ASC 840's direct-financing leases)
- Type A leases that would be recognized and measured in accordance with ASC 606 (also refer to the lease classification section above)

Under the new standard, lessors would account for a Type B lease using an approach similar to ASC 840's operating leases.

Lessors would account for Type A leases with and without selling profit using approaches similar to ASC 840's guidance for sales-type and direct financing leases, respectively. However, there would be two key differences. First, the initial recognition of selling profit (if any) on a Type A lease would be deferred if the lease does not, in effect, transfer control of the underlying asset to the lessee. Second, a lessor would follow the guidance in ASC 606 if a lease would otherwise be a Type A lease with recognized selling profit except that the collection of lease payments is not probable. These differences are discussed further in the lessor accounting concepts section below.

Under the new standard, leveraged lease accounting would be eliminated for new leases after the effective date. That is, lessors would account for new leases, including those that would qualify as leveraged leases under ASC 840, using the classifications discussed above. However, leveraged leases that exist at transition would be grandfathered. Refer to Appendix B for further discussion on leveraged lease accounting.

Lessor accounting concepts

At lease commencement, lessors would apply the key concepts described earlier in this publication to determine the initial direct costs, lease term, lease payments and discount rate. Lessors would also apply the following concepts to recognize and measure their Type A leases.

Net investment in the lease

A lessor's net investment in a Type A lease would consist of the lease receivable and any unguaranteed residual asset.

- Lease receivable — The lease receivable would be the total lease payments (see the lease payments section above) discounted using the rate implicit in the lease and any guaranteed residual asset. Initial direct costs incurred as part of Type A leases without recognized selling profit would be included in the lease receivable. However, initial direct costs related to Type A leases with initially recognized selling profit would be expensed at lease commencement.

- Unguaranteed residual asset — The unguaranteed residual asset would be the lessor's right to the expected unguaranteed value of the leased asset at the end of the lease.

- Deferred selling profit — Selling profit would be deferred and would reduce the lessor's net investment in the lease when the lessor does not, in effect, transfer control of the underlying asset to the lessee.

Selling profit or loss

Selling profit would be the difference (if any) between the fair value of the underlying asset and its carrying amount. Leases that give rise to a manufacturer's or dealer's profit or loss to the lessor normally result when a company uses leasing as a means of marketing its products. A loss upon sale would be recognized immediately, but a loss may indicate that the underlying asset was impaired prior to the transaction.

Determining whether to defer or recognize selling profit – Type A leases with selling profit

For purposes of determining whether selling profit should be initially recognized or deferred, the new standard would require a lessor to determine whether the lease, in effect, transfers control of the underlying asset to the lessee. This evaluation considers the lease classification criteria applicable to lessees and lessors (discussed above), except that the control evaluation would exclude any risks and rewards transferred to parties other than the lessee. For example, a lessor would exclude residual value guarantees or asset buyback commitments from a third party unrelated to the lessee when evaluating whether selling profit can be recognized. Under this evaluation, control would be deemed to have transferred if any one of those lease classification criteria is met and selling profit would be recognized assuming that collectibility of the lease payments is probable.

The new standard would include this additional condition for the recognition of initial selling profit to better align the leases guidance with the principles in the new revenue recognition standard (i.e., ASC 606). That is, a lessor would evaluate the transfer of control of the underlying asset from the **lessee's** perspective and consider the risks and rewards transferred to only the lessee, just as the new revenue recognition standard requires control to be evaluated from the customer's perspective. However, if the lessee does not obtain control of the underlying asset, the lessor would defer any initial selling profit and amortize it over the lease term in a manner that, when combined with the interest income on the lease receivable and the unguaranteed residual asset, would produce a constant periodic rate of return on the lease.

How we see it

A lessor's recognition of initial selling profit for leases of part of a real estate asset (e.g., a floor of a building) under the new standard would be a significant change from current practice.

Key differences between US GAAP and IFRS
Under the IASB's new standard, lessors would be permitted to initially recognize profit (if any) on all Type A leases including those with significant third-party residual value guarantees. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Collectibility

The new standard would require lessors to evaluate the collectibility of lease payments to determine lease classification. Refer to the lease classification section above. This assessment would also affect the recognition and measurement of leases. A lessor would follow the guidance in ASC 606 if a lease would otherwise be a Type A lease with recognized selling profit except that the collection of lease payments is not probable. A lessor would apply the recognition and measurement provisions for a Type B lease to a lease that would otherwise be a Type A lease with deferred selling profit or no selling profit except that the collection of lease payments is not probable.

Type B leases

Lessors' Type B leases would be similar to today's operating leases.

Lessors would account for Type B leases in a manner similar to today's operating leases. That is, they would continue to recognize the underlying asset. At lease commencement for Type B leases, lessors would not recognize a net investment in the lease (i.e., a lease receivable and any unguaranteed residual asset) on the balance sheet or initial profit (if any) on the income statement. The underlying asset would continue to be accounted for in accordance with applicable accounting standards (e.g., ASC 360).

Lessors would recognize lease payments from Type B leases over the lease term on either a straight-line basis or another systematic basis if that basis better represents the pattern in which income is earned from the underlying asset. Lessors in a Type B lease would recognize initial direct costs as an expense over the lease term on the same basis as lease income.

In some cases, another systematic basis of accounting might better represent the pattern in which the lessor earns income. For example, variable lease payments that do not depend on an index or rate would be recognized as they are earned (i.e., when the variable payments become receivable). Likewise, "stepped" rent increases that are intended to compensate a lessor for expected increases in market rental rates would be recognized based on the contractual cash flows (i.e., as the stepped payments become receivable). In both examples, revenue would be recognized on a basis other than straight line because it better reflects the pattern in which the revenue is earned.

If lease payments are uneven for reasons other than to compensate the lessor for expected increases in market rentals or changes in market conditions, the lease revenue would be recognized on a straight-line basis. For example, lease payments might be front-loaded or back-loaded or a lease might include a rent-free period. The uneven pattern of these lease payments generally would not be related to the way in which the lessor earns revenue. Therefore, they would not support revenue recognition on a basis other than straight line.

How we see it

Determining that lease payments in a Type B lease should be recognized on a basis other than straight line would likely require judgment. There might not be a clear distinction between increases in scheduled lease payments that reflect the pattern in which lease income is earned (e.g., "stepped" increases intended to compensate the lessor for changes in the market rentals or market conditions) and other scheduled increases that do not.

Type A leases with selling profit — recognized or deferred

Initial recognition and measurement

Upon commencement of a Type A lease with selling profit, lessors would:

- Derecognize the carrying amount of the underlying asset
- Recognize the net investment in the lease
- Recognize, in net income, selling profit on leases in which the lessee, in effect, obtains control of the underlying asset
- Defer selling profit on leases in which the lessee, in effect, does not obtain control of the underlying asset

Subsequent measurement

After lease commencement, lessors would account for a Type A lease with selling profit as follows:

- Recognize interest income (in profit or loss) over the lease term using the rate implicit in the lease on the components of the net investment in the lease, including:
  - Interest on the lease receivable
  - Accretion of the unguaranteed residual asset to its expected undiscounted value at the end of the lease
- Amortize any deferred selling profit as interest income over the lease term in a manner that, when combined with the interest income on the lease receivable and the unguaranteed residual asset, would produce a constant periodic rate of return on the lease — only applicable for Type A leases with selling profit for which control has not transferred to the lessee
- Reduce the net investment in the lease for lease payments received (net of interest income and recognized profit calculated above)
- Separately recognize income from variable lease payments that are not included in the net investment in the lease (e.g., performance- or usage-based variable payments) in the period in which that income is earned

Type A leases with no selling profit

Initial recognition and measurement

Upon commencement of a Type A lease with no selling profit, lessors would:

- Derecognize the carrying amount of the underlying asset
- Recognize the net investment in the lease

Subsequent measurement

After lease commencement, lessors would account for a Type A lease with no selling profit as follows:

- Recognize interest income (in profit or loss) over the lease term using the rate implicit in the lease on the components of the net investment in the lease, including:
  - Interest on the lease receivable
  - Accretion of the unguaranteed residual asset to its expected undiscounted value at the end of the lease

- Reduce the net investment in the lease for lease payments received (net of interest income calculated above)
- Separately recognize income from variable lease payments that are not included in the net investment in the lease (e.g., performance- or usage-based variable payments) in the period in which that income is earned

Type A leases that would be recognized and measured under ASC 606

A lessor would recognize and measure a lease with selling profit that, in effect, transfers control of the underlying asset to the lessee for which collectibility of lease payments is not probable in accordance with the new revenue recognition standard.

If collection of the lease payments for those leases is not probable, the lessor would defer income recognition (i.e., a deferral of income similar to the new revenue standard).

How we see it

Lessors should monitor the discussions of the FASB for any potential amendments to the new revenue recognition standard.

Reassessment

Lessors would not be required to reassess the lease term or lease payments after lease commencement. Refer to Appendix A for a summary of lessee and lessor reassessment requirements. If a lease is modified, refer to the lease modifications section above.

Other lessor matters in Type A leases

Sale of lease receivables

The new standard would require lessors to measure all lease receivables, including those held for sale, at amortized cost.

How we see it

We expect the Basis for Conclusions to indicate that it would be appropriate for lessors to apply the existing financial asset derecognition guidance in ASC 860, *Transfers and Servicing*, when they sell lease receivables, including any guaranteed residual values.

Impairment of the net investment in the lease

The new standard would require lessors to evaluate their entire net investment in the lease (when applicable) for impairment using the guidance in ASC 310. This is a change from the 2013 ED that would have required lessors to apply the impairment guidance in ASC 310 to lease receivables and ASC 360 to the unguaranteed residual asset.

Classification of the underlying asset at the end of a lease

At the end of the lease term, lessors may receive the underlying asset back from the lessee. Under the new standard, lessors would reclassify the carrying amount of the unguaranteed residual asset to the applicable category of assets (e.g., property, plant and equipment). Thereafter, lessors would account for the underlying asset using other applicable accounting guidance (e.g., ASC 360).

Income tax accounting

The new standard could affect lessors' accounting for income taxes. Applying the new standard could change the recognition of lease-related assets (i.e., lease receivables and any unguaranteed residual assets), the measurement of lease-related assets and the derecognition of underlying assets for certain leases that are subject to operating leases today. The new standard also would change the timing of recognition of lease income for some leases. In addition, the special accounting for leveraged leases would be eliminated, except for leveraged leases that exist at the transition date, which would be grandfathered.

These changes could affect many aspects of accounting for income taxes, such as the following:

- Recognition and measurement of deferred tax assets and liabilities
- Assessment of the recoverability of deferred tax assets (i.e., the need for and measurement of valuation allowances)

Presentation

The table below summarizes how lease-related amounts and activities would be presented in lessors' financial statements. The FASB has not addressed presentation of Type A leases that would be recognized and measured in accordance with the new revenue recognition standard.

Financial statement	Lessor presentation
Balance sheet	‣ **Type A leases:** ‣ Lease assets (i.e., lease receivables and unguaranteed residual assets) would be presented separately from other assets ‣ Lease receivables and unguaranteed residual assets could be presented separately from each other or, if presented together (i.e., the net investment in the lease), they would be separately disclosed in the notes ‣ **Type B leases:** Underlying assets would be presented in accordance with applicable guidance
Income statement	‣ **Both types of leases:** Income arising from leases would be presented separately from other activity, or disclosed in the notes (along with the corresponding line item(s) in the income statement), although when leasing activity is material, public business entities would be required to present such activity separately ‣ **Type A leases:** ‣ Profit or loss recognized at the commencement date would be presented on either a gross or net basis, based on the lessor's business model ‣ Lessors that use leasing as an alternative means of realizing value from goods they would otherwise sell would present lease revenue and cost of goods sold on a gross basis (i.e., revenue and costs in separate line items) ‣ Lessors that use leases for the purpose of providing finance would present the gain or loss on a net basis (i.e., in a single line item) ‣ Interest on the net investment in the lease would be presented as interest income
Statement of cash flows	‣ **Both types of leases:** Cash lease payments received would be presented within operating activities

Disclosure

The disclosures that would be required for lessors are intended to help financial statement users understand the amount, timing and uncertainty of lease-related cash flows. These disclosures would include the amounts of recognized lease-related assets and liabilities, significant judgments and assumptions about lease terms, payments, the existence of residual value guarantees and options to extend or terminate a lease. Lessors would exercise judgment to determine the level at which to aggregate, or disaggregate, the disclosures. Disclosures would need to be disaggregated or aggregated at an appropriate level so that the information is meaningful to the financial statement users and is not obscured by insignificant details or by grouping items with different characteristics. The FASB has not addressed disclosures for Type A leases that would be recognized and measured in accordance with the new revenue recognition standard.

General disclosure requirements

Lessors would be required to disclose information about the nature of leases, such as:

- A general description of the leases
- The basis, and terms and conditions, on which variable lease payments are determined
- The existence, and terms and conditions, of options to extend or terminate the lease
- The existence, and terms and conditions, of options for a lessee to purchase the underlying asset

Lessors would be required to disclose more information about how they manage the risks related to residual values of assets under lease.

As noted above, the new standard would also require lessors to disclose information about the significant judgments and assumptions made in accounting for leases. For example, a lessor might disclose information about its judgments and assumptions associated with:

- The determination of whether a contract contains a lease
- The identification of the lease and non-lease components of a contract
- The allocation of the consideration in a contract between the lease and non-lease components
- The initial measurement of the residual asset included in the net investment in the lease
- Any other means by which the lessor reduces its residual asset risk (e.g., buyback agreements, variable lease payments for lessee use in excess of specified limits)

Lessors would also disclose lease income recognized in the reporting period, in a tabular format. The disclosure would include:

- For Type A leases:
  - Profit or loss recognized at the commencement date (presented gross or net, consistently with the lessor's business model)
  - The interest income on net investments in leases (i.e., lease receivables and unguaranteed residual assets), either individually for each component of the net investment or in the aggregate
- For Type B leases, lease income relating to lease payments
- Lease income relating to variable lease payments not included in the measurement of net investments in Type A leases

Other quantitative and qualitative disclosures — Type A leases

Under the new standard, lessors would be required to qualitatively and quantitatively explain significant changes in residual values of assets under Type A leases. However, disclosure of significant changes in the lease receivable portion of the net investment would follow other US GAAP.

Key differences between US GAAP and IFRS
Under the IASB's new standard, lessors would be required to explain significant changes in the net investment in both qualitative and quantitative terms. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

To help financial statement users understand and evaluate liquidity risks of lease-related cash flows, lessors would be required to disclose a maturity analysis of undiscounted cash flows to be received, on an annual basis, for five years after the balance sheet date, and in total thereafter, that comprise Type A lease receivables and a reconciliation to lease receivables presented on the balance sheet (or in the notes).

Other quantitative disclosures — Type B leases

Lessors would be required to provide a separate maturity analysis of the undiscounted future lease payments to be received for Type B leases, as of the reporting date. The maturity analysis would include undiscounted cash flows to be received, on an annual basis, for five years after the balance sheet date, and in total thereafter.

For assets leased under Type B leases, lessors would be required to disclose the same information that is currently required under ASC 360 for property, plant and equipment (e.g., balances by major class, accumulated depreciation, a general description of method of computing depreciation).

Other considerations

Subleases

Lessees often enter into arrangements to sublease a leased asset to a third party while the original lease contract remains in effect. In these arrangements, one party acts as both the lessee and lessor of the same underlying asset. The original lease is often referred to as a head lease, the original lessee is often referred to as an intermediate lessor and the ultimate lessee is often referred to as the sub-lessee.

Intermediate lessor accounting

An intermediate lessor would assess sublease classification independently of the classification assessment that it makes as the lessee of the same asset. Under the new standard, an intermediate lessor would consider the lease classification criteria with reference to the underlying asset when classifying a sublease. See the lease classification section above.

Key differences between US GAAP and IFRS
Under the IASB's new standard, intermediate lessors would be required to consider the right-of-use asset when determining sublease classification. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

An intermediate lessor generally would account for a head lease (as a lessee) and a sublease (as a lessor) as two separate lease contracts. However, when contracts are entered into at or near the same time, an intermediate lessor would be required to consider the criteria for combining contracts (i.e., whether the contracts are negotiated as a package with a single commercial objective or the consideration to be paid in one contract depends on the price or performance of the other contract. See the contract combinations section above for more information. If either criterion is met, the intermediate lessor would account for the head lease and sublease as a single combined transaction.

Today's guidance for subleases that are loss contracts would be eliminated. Therefore, intermediate lessors would assess right-of-use-assets that are subject to a sublease for impairment under the long-lived asset impairment provisions of ASC 360. Refer to Appendix B for a summary of current US GAAP lease and lease-related accounting guidance that would be eliminated under the new standard and guidance that may be eliminated pending further FASB discussions.

Sub-lessee accounting

The FASB concluded that a sub-lessee would classify the sublease by referring to the underlying asset rather than by referring to the right-of-use asset arising from the head lease.

Presentation

Intermediate lessors would generally present sublease revenues on a gross basis.

Intermediate lessors would not be permitted to offset lease liabilities and lease assets that arise from a head lease and a sublease, respectively, unless those liabilities and assets meet the requirement of ASC 210-20, *Balance Sheet — Offsetting*, for offsetting financial instruments. Intermediate lessors would apply the principal-agent guidance from the new revenue recognition standard (refer to ASC 606-10-55-36 through 55-40) to determine whether sublease revenue should be presented on a gross or net basis (i.e., reduced for head lease expenses). The FASB expects that intermediate lessors would generally present sublease revenue on a gross basis.

How we see it

Various aspects of the new standard (e.g., the principal-agent considerations for sublease revenue) would align with the new revenue recognition standard (i.e., ASC 606). Lessors should familiarize themselves with the new revenue standard because it could also influence their accounting for leases. In addition, lessors should monitor developments as the Board considers amending the new revenue standard.

Disclosure

In addition to the lessee and lessor disclosure requirements discussed previously, the new standard would require an intermediate lessor to disclose the following information relating to its subleases:

- A general description of the leases
- The basis, and terms and conditions, on which variable lease payments are determined
- The existence, and terms and conditions, of options to extend or terminate the lease
- The existence, and terms and conditions, of residual value guarantees provided by the sub-lessee
- The restrictions or covenants imposed by leases (e.g., those related to dividends or incurring additional financial obligations)

Business combinations

Classification of acquired leases

The new standard would require an acquirer to classify acquired leases using the contractual terms and conditions at the commencement date of the lease. If the contractual terms and conditions of a lease are modified as part of the business combination, the acquirer would classify the new lease based on the contractual terms and conditions of that new lease.

How we see it

- Under the new standard, no lease assets and liabilities would be recognized for acquired leases that have a remaining term of 12 months or less. We believe the acquirer would generally recognize lease payments on a straight-line basis over the remaining lease term following the business combination.
- It is unclear whether the acquirer's accounting for leases with a remaining term of 12 months or less would preclude the recognition of assets and liabilities for off-market contract terms or in-place leases. Precluding the recognition of these assets and liabilities would be inconsistent with the principles in ASC 805, *Business Combinations*, that typically result in the recognition of assets and liabilities for both the in-place leases and related off-market terms of contracts.

Acquiree in a business combination is a lessee

Initial measurement of a lease

The acquirer would measure the acquired lease liability as if the lease contract were a new lease at the acquisition date. That is, the acquirer would apply the new standard's initial measurement provisions, using the present value of the remaining lease payments at the acquisition date. The acquirer would follow the guidance for determining the lease term, lease payments and discount rate. The right-of-use asset would be measured at an amount equal to the recognized liability, adjusted to reflect both of the following:

- Favorable or unfavorable terms of the lease, relative to market terms
- Any other intangible asset associated with the lease, which may be evidenced by market participants' willingness to pay for the lease even if it is at market terms (e.g., a lease of gates at an airport, a lease of retail space in a prime shopping area that provides entry to the market or other future economic benefits that qualify as an intangible asset)

Because the off-market nature of the lease would be captured in the right-of-use asset, the acquirer would not separately recognize an intangible asset or liability for favorable or unfavorable lease terms relative to market. The classification of the lease would not affect the initial measurement of the lease liability or the right-of-use asset.

Subsequent measurement of a lease

The subsequent measurement of an acquired lease liability and right-of-use asset would be determined using the subsequent measurement guidance for pre-existing lease arrangements (refer to the lessee accounting section above).

Acquiree in a business combination is a lessor

Initial measurement of a lease when the acquiree is a Type A lessor

The acquirer would measure a lease receivable as if the lease contract were a new lease at the acquisition date (i.e., measured at the present value of the remaining lease payments). The acquirer would use the key concepts described previously to determine the lease term, lease payments and discount rate. An unguaranteed residual asset would be initially measured as the difference between the acquisition date fair value of the underlying (acquired) asset and the initial measurement of the lease receivable portion of the net investment in the lease. The acquirer would take into consideration the terms and conditions of the lease (e.g., off-market terms) when calculating the acquisition date fair value of the underlying asset. An acquirer would not recognize a separate intangible asset or liability for favorable or unfavorable terms, relative to market.

Initial measurement of a lease when the acquiree is a Type B lessor

Underlying assets subject to Type B leases would remain on the lessor's balance sheet. Therefore, when an acquiree is a lessor, an underlying asset subject to a Type B lease would be recognized on the acquirer's balance sheet and initially measured at fair value. The acquirer would consider the terms and conditions of the lease (e.g., off-market terms) when measuring the fair value of the underlying asset (e.g., a building). No separate intangible asset or liability for favorable or unfavorable terms relative to market would be recognized.

Subsequent measurement of a lease

The subsequent measurement of the net investment in a Type A lease would be determined using the subsequent measurement guidance for pre-existing lease arrangements (see the lessor accounting section above). The subsequent measurement of the underlying asset subject to a Type B lease would be determined using other applicable accounting guidance (e.g., ASC 360).

To determine how to account for a sale and leaseback transaction, a seller-lessee would consider the control criteria in the new revenue standard.

How we see it

The FASB did not revisit its 2013 proposals on leases acquired in business combinations in redeliberations. The FASB may need to align the new guidance in the final standard to reflect its decisions on lease classification and lessee and lessor accounting.

Sale and leaseback transactions

Because lessees would recognize most leases on the balance sheet (i.e., all leases except for short-term leases depending on the lessee's accounting policy election), sale and leaseback transactions would no longer provide lessees with a source of off-balance sheet financing.

A seller-lessee would use the definition of a sale in the new revenue recognition standard (i.e., ASC 606), in conjunction with additional guidance described below, to determine whether a sale has occurred in a sale and leaseback transaction. The seller-lessee would assess whether the buyer-lessor has gained control of the underlying asset. Control of an underlying asset refers to the ability to direct the use of the asset and obtain substantially all of the remaining benefits from the asset.

If control of an underlying asset passes to the buyer-lessor, the transaction would be accounted for as a sale and a lease by the lessee. If not, the transaction would be accounted for as a financing.

The FASB decided to retain the guidance in the 2013 ED that a buyer-lessor would account for the purchase of the underlying asset consistent with the guidance that would apply to any other purchase of a nonfinancial asset (i.e., without the presence of the leaseback).

How we see it

We generally expect more transactions to be accounted for as sales and leasebacks under the new standard than under today's standard.

Ability to direct the use of an underlying asset

While the concepts of "control" in the new leases standard and the new revenue recognition standard (i.e., ASC 606) are similar, a key difference exists. Under the new leases standard, the right to control the use of an underlying asset would involve the right to direct how and for what purpose the asset is used throughout the period of its use. Under ASC 606, control will be based on a broader consideration of rights with respect to the asset over its entire useful life.

The presence of a leaseback, in and of itself, would not preclude a sale. However, the FASB decided that a sale and a purchase would not occur when a leaseback involves a Type A lease from the seller-lessee's perspective. The FASB believes that a lessee's Type A lease is effectively a financed purchase of the underlying asset. Therefore, it would be inappropriate for a seller-lessee to account for the sale of an underlying asset that it concurrently repurchases. Instead, these transactions would be accounted for as financings.

While a seller's repurchase option would generally preclude sale accounting under ASC 606, the new leases standard would specify that repurchase options would not preclude sale accounting when **all** of the following conditions are met:

- The option is exercisable only at the then-prevailing fair market value (i.e., at the time of exercise) of the underlying asset.
- The underlying asset is a non-specialized asset.
- The underlying asset is readily available in the marketplace.

The FASB believes that such a repurchase option is effectively non-substantive in the context of a sale and leaseback transaction and therefore should not preclude sale accounting in such a transaction. The FASB staff indicated that it believes real estate would not meet the non-specialized asset condition above.

How we see it

- During redeliberations, the FASB discussed an example of a leased automobile and appeared to agree that such an asset would generally be non-specialized and would be readily available in the marketplace. However, determining when an underlying asset is non-specialized and readily available in the marketplace could require judgment.
- In a sale and leaseback transaction, it is unclear whether options to extend a lease for the remaining economic life of the underlying asset would be evaluated in the same manner as purchase options under the new revenue standard (i.e., ASC 606).

Key differences between US GAAP and IFRS

Under the IASB's new standard, no sale would occur when the seller-lessee has a substantive repurchase option. The IASB does not plan to provide further guidance about when repurchase options would be considered substantive. Additionally, sale accounting is not prohibited for Type A leasebacks because all leases are Type A leases for lessees under the IASB's new standard.

Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Transactions in which the buyer-lessor obtains control of the underlying asset

Accounting for the sale

When the seller-lessee transfers control of the underlying asset to the buyer-lessor in a sale and leaseback transaction, the seller-lessee would do each of the following:

- Derecognize the underlying asset
- Recognize a lease liability and right-of-use asset for the leaseback (subject to the optional exemption for short-term leases)
- Recognize the gain or loss, if any, immediately (adjusted for off-market terms)

Key differences between US GAAP and IFRS
Under the IASB's new standard, gain recognition would be limited to the portion related to the buyer-lessor's residual asset. The remaining gain would be recognized as a reduction to the initial measurement of the seller-lessee's right-of-use asset and thus reflected as a reduction in amortization of the right-of-use asset over the term of the leaseback. Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Accounting for the leaseback

When a sale occurs, both the seller-lessee and the buyer-lessor would account for the leaseback in the same manner as any other lease (i.e., in accordance with the lessee and lessor guidance, respectively, with adjustments for any off-market terms).

Adjustment for off-market terms

The sale transaction and the ensuing lease are generally interdependent and negotiated as a package. Consequently, in some cases the transaction could be structured with a negotiated sales price above fair value and with lease payments for the ensuing lease above the then-current market rates, or vice-versa. Under either scenario, the off-market terms could distort the gain on sale (or disposition) and the recognition of lease expense for the ensuing lease. To ensure that the gain or loss on disposition and the lease-related assets and liabilities associated with such transactions are not understated or overstated, the FASB decided to require adjustments for any off-market elements of sale and leaseback transactions.

The off-market adjustments would be determined using the fair value of the underlying asset or the market lease payments, whichever provides the more readily determinable evidence. Entities would be expected to maximize the use of observable prices and information when determining which measure is the most appropriate to use.

When the sale price is (or the total lease payments are) less than the underlying asset's fair value (or the total market lease payments), a seller-lessee would increase the initial measurement of the right-of-use asset. This treatment would be similar to the accounting for lease prepayments under the new standard. When the sale price is (or the total lease payments are) greater than the underlying asset's fair value (or the total market lease payments), a seller-lessee would recognize an additional financial liability (i.e., additional financing received from the buyer-lessor) separately from the lease liability.

Buyer-lessors would also be required to adjust the purchase price of the underlying asset for any off-market terms. Such adjustments would be recognized as lease prepayments made by the seller-lessee or as additional financing provided to the seller-lessee.

Adjustments would not be made to reflect either the fair value of the purchase and sale or the current market rates for the lease in sale and leaseback transactions among related parties. Refer to the related party leasing transactions section above.

Disclosure

A seller-lessee in a sale and leaseback transaction would be required to disclose:

- The main terms and conditions of the transaction
- Any gains or losses arising from the transaction separately from gains or losses on disposal of other assets

Effective date and transition

Effective date

The FASB has not yet discussed an effective date but plans to address it in the fourth quarter of 2015.

How we see it

Given the current timeline, we believe an effective date of 1 January 2018 or later is likely.

A final standard is not likely to be effective before 1 January 2018.

Transition

The new standard's transition provisions would be applied as of the beginning of the earliest comparative period presented in the financial statements (date of initial application). For example, assuming an effective date of 1 January 2018, a calendar-year company that presents three-year comparative financial statements would apply the transition provisions on 1 January 2016 (i.e., the beginning of the earliest comparative period presented).

Lessees and lessors would be required to apply the new standard using a modified retrospective approach for all leases existing at, or entered into after, the date of initial application, with an option to use certain transition relief (discussed below).

Lessees and lessors would be prohibited from using a full retrospective transition approach.

Lessee transition — capital leases

For capital leases existing at, or entered into after, the date of initial application, a lessee would:

- Initially recognize a Type A right-of-use asset and lease liability at the later of (1) the date of initial application and (2) the date of initial recognition under ASC 840, measured at the carrying amount of the capital lease asset and capital lease obligation under ASC 840
- Recognize as part of the Type A right-of-use asset any unamortized initial direct costs not included in the capital lease asset under ASC 840 that would have qualified for capitalization under the new standard and write-off costs that would not have qualified for capitalization under the new standard as an adjustment to equity
- Subsequently measure the Type A right-of-use asset and lease liability in accordance with the subsequent measurement guidance in ASC 840 in the periods prior to the effective date

Beginning on the effective date, lessees would subsequently measure the Type A right-of-use asset and lease liability in accordance with the subsequent measurement guidance in the new standard, except that a lessee would not remeasure the Type A right-of-use asset or lease liability for changes in the amount the lessee expects to pay under residual value guarantees unless it remeasures the asset or liability for other reasons (e.g., because of a change in the lease term resulting from a reassessment). If a lease is modified after the effective date or the lease liability is remeasured for any reason, lessees would account for the lease under the new standard. For lease modifications, this would be the case, regardless of whether the modification results in a separate lease.

Lessee transition — operating leases

For operating leases existing at, or entered into after, the date of initial application, a lessee would:

- Initially recognize a Type B right-of-use asset and lease liability at the later of (1) the date of initial application and (2) lease commencement
- Initially and subsequently measure the lease liability at the present value of the sum of the following items unless the lease is modified or the lease liability is required to be remeasured on or after the effective date:
  - The remaining minimum rental payments (as described under ASC 840)
  - Any amounts the lessee expects to pay to satisfy a residual value guarantee
- Use a discount rate established in accordance with the new leases standard as of the later of (1) the date of initial application and (2) lease commencement
- Measure the Type B right-of-use asset throughout the lease at an amount equal to the lease liability, adjusted for any prepaid or accrued rent, lease incentives or unamortized initial direct costs that would have qualified for capitalization under the new leases standard
- Write off, as an adjustment to equity, any unamortized initial direct costs that would not have qualified for capitalization under the new leases standard

Beginning on the effective date, lessees would account for a lease modification or remeasurement of the lease liability under the new standard. For lease modifications, this would be the case, regardless of whether the modification results in a separate lease.

Lessor transition — sales-type and direct financing leases

For sales-type and direct financing leases existing at, or entered into after, the date of initial application, a lessor would:

- Not reassess whether a sales-type lease would have qualified for up-front selling profit recognition in accordance with the new leases standard
- Initially recognize a net investment in the lease at the later of (1) the date of initial application and (2) lease commencement, measured at the carrying amount of the net investment in the lease under ASC 840
- Include in the net investment in a direct financing lease any unamortized initial direct costs that were capitalized in accordance with ASC 840
- Subsequently measure the net investment in the lease in accordance with the subsequent measurement guidance in ASC 840 in the periods prior to the effective date

Beginning on the effective date, the lessor would subsequently measure the net investment in the lease in accordance with the subsequent measurement guidance in the new standard. If the lease is modified after the effective date, lessors would account for the lease under the new standard, regardless of whether the modification results in a separate lease.

Lessor transition — operating leases

For operating leases existing at, or entered into after, the date of initial application, the carrying amount of the underlying asset and any lease assets or liabilities (for example, prepaid or deferred rent) would be the same as that recognized under ASC 840 at the later of (1) the date of initial application and (2) lease commencement.

A lessor would recognize any initial direct costs that would have qualified for capitalization under the new leases standard as an expense over the lease term on the same basis as lease income. Those costs that would not have qualified for capitalization under the new standard would be written off as an adjustment to equity.

If a lessor had previously securitized receivables arising from leases that were classified as operating leases in accordance with ASC 840, the lessor would account for those transactions as secured borrowings in accordance with other GAAP.

Other considerations — transition relief (policy election)

Lessees and lessors would be permitted to make an accounting policy election to apply the following relief which must be elected as a package and must be consistently applied to all leases (i.e., an entity cannot choose which provisions to apply or which leases to apply them to). In addition, an entity that is both a lessee and a lessor must make the election regarding relief for all leases.

Lessees and lessors could elect not to reassess all of the following:

- Whether any expired or existing contracts are or contain leases
- Lease classification for any expired or existing leases
- Initial direct costs for any expired or existing leases (i.e., whether those costs would have qualified for capitalization under the new leases standard)

Lessees and lessors would also be permitted to make an accounting policy election to use hindsight with respect to lease renewals and purchase options when accounting for existing leases. This relief may be elected separately or in conjunction with the package of relief described above. An entity would have to make an accounting policy election (i.e., it could not elect this relief on a lease-by-lease basis).

How we see it

Because the current accounting for operating leases and service contracts is similar, determining whether an arrangement is a lease or service contract might not have been a focus for many entities. Given the consequences of the new standard, the effects of treating an arrangement as a service instead of a lease may be material when it may not have been material in the past. This may require some entities to revisit the assessment made under ASC 840.

Disclosures

Lessees and lessors would be required to provide transition disclosures in accordance with ASC 250, *Accounting Changes and Error Corrections*, without the disclosure of the effect of the change on income from continuing operations, net income, any other affected financial statement line item and any affected per-share amounts for the current period and any prior periods that are adjusted.

Sale and leaseback transition

A seller-lessee would reassess whether there was a sale in a sale and leaseback transaction only when the transaction is still being accounted for as a "failed sale" (i.e., a financing) under ASC 840, at the effective date of the new standard. Transactions previously determined to be sales by a seller-lessee would not be reassessed.

However, a seller-lessee would account for any deferred gain or loss on a transaction previously accounted for as a sale and leaseback as follows:

- For leasebacks classified as capital leases, the entity would continue amortizing the gain or loss in the same manner as under ASC 840.
- For leasebacks classified as operating leases, the entity would recognize any deferred gain or loss not resulting from off-market terms as an adjustment to equity. Any deferred amount that is the result of off-market terms would be recognized as an adjustment to the right-of-use asset if the amount is a loss or as a financial liability if it is a gain.

Seller-lessees would account for the leaseback in accordance with the lessee transition requirements.

Build-to-suit arrangement transition

As discussed in Appendix B, build-to-suit accounting would be eliminated under the new standard. As part of transition, lessees would be required to apply a modified retrospective transition approach for build-to-suit lease arrangements existing at, or entered into after, the date of initial application.

An entity that has recognized assets and liabilities as a result of the build-to-suit guidance in ASC 840 would derecognize those assets and liabilities at the later of (1) the date of initial application and (2) the date that the lessee is determined to be the accounting owner of the asset under existing build-to-suit guidance. Any difference between the amounts of the assets and the liabilities derecognized would be recorded as an adjustment to equity at that date. The lessee would then follow the general lessee transition guidance for the lease.

Key differences between US GAAP and IFRS

While the FASB's new standard would prohibit the use of a full-retrospective transition approach, the IASB's new standard would permit such an approach.

The FASB would require adoption of its new standard using a modified retrospective transition approach. The IASB would permit such a transition approach. However, the FASB and the IASB would require the modified retrospective approach to be applied differently and would provide different types of transition relief.

Refer to Appendix C for a summary of key differences between US GAAP and IFRS.

Endnotes:

[1] ASC 840-10-25-42 requires lessors to consider all four lease classification criteria in paragraph 840-10-25-1 and both of the following criteria: (a) collectibility of the minimum lease payments is reasonably predictable, and (b) no important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.

[2] See Proposed Accounting Standards Update (Revised), *Leases (Topic 842),* on the FASB's website.

[3] A service concession arrangement is an arrangement between a public-sector entity grantor and an operating entity under which the operating entity generally operates the grantor's infrastructure (e.g., an airport, road, bridge, tunnel) for a specified period of time. Refer to our Financial reporting developments publication, *Lease accounting*, for further information.

[4] ASU 2015-05, *Customer's Accounting for Fees Paid in a Cloud Computing Arrangement*.

[5] See ASC Master Glossary for definition of public business entity.

[6] For lessees, see the Lessee Accounting Model March 2014 staff paper 3A paragraph 36. For lessors, see the Lessor Accounting Model March 2014 staff paper 3C paragraph 19.

Appendix A: Summary of lessee and lessor reassessment requirements (updated July 2015)

	Lessees	Lessors
Allocating contract consideration	Reallocate contract consideration upon either of the following events: ‣ A contract modification that is not accounted for as a separate, new lease. ‣ A reassessment of the lease term or whether the lessee is reasonably certain to exercise an option to purchase the underlying asset.	Reallocate contract consideration upon a contract modification that is not accounted for as a separate, new lease.
Lease term	Reassess upon the occurrence of significant events or changes in circumstances that are within the lessee's control (i.e., market-based events or changes would not trigger a reassessment).	No requirement to reassess after lease commencement.
Variable lease payments that depend on an index or rate	Reassess when the lease liability is remeasured for other reasons (e.g., due to a change in the lease term).	No requirement to reassess after lease commencement.
Amounts expected to be payable under residual value guarantees — lessees only	Remeasure the lease liability and adjust the right-of-use asset if the amounts expected to be payable under residual value guarantees change during the lease term. Recognize the remaining adjustment in profit or loss if the right-of-use asset is reduced to zero.	Not applicable for lessors because lease payments would generally exclude amounts receivable under residual value guarantees (from the lessee or a third party).
Discount rate	Reassess upon a lease modification, a change to the lease term or a change to the assessment of whether a lessee is reasonably certain to exercise an option to purchase the underlying asset.	Reassess upon a modification to a Type A lease that does not result in a separate, new lease when the modified lease remains a Type A lease (i.e., when lease classification does not change).
Lease classification	It is unclear whether lessees would reassess lease classification upon a modification to a Type A or Type B lease that does not result in a separate, new lease.	Reassess upon a modification to a Type A lease that does not result in a separate, new lease. It is unclear whether lessors would reassess lease classification upon a modification to a Type B lease that does not result in a separate, new lease.

Appendix B: US GAAP guidance that would be eliminated and guidance the FASB may eliminate (updated July 2015)

This appendix discusses accounting guidance that the FASB would eliminate under the new standard. This appendix also discusses interpretive guidance in ASC 840 that the FASB did not include in its 2013 ED. At its May 2015 meeting, the FASB indicated that its staff plans to revisit this guidance to determine whether to would be carried forward to the new standard.

Guidance that would be eliminated under the new standard

Lessee involvement in asset construction ('build-to-suit' transactions)

Build-to-suit lease transactions involve various forms of lessee involvement in the construction of an asset for the lessee's own use. Under ASC 840, a lessee is considered the owner of an asset during the construction period if it takes on substantially all of the construction-period risks. If the lessee is considered the owner of the asset during the construction period, a deemed sale and leaseback of the asset would occur when construction of the asset is completed and the lease term begins. The 2013 ED proposed eliminating this guidance. In the Basis for Conclusions in the 2013 ED, the FASB said entities would apply other existing guidance (e.g., ASC 360) when costs are incurred to construct or design an asset before that asset is ready for use. If the lessee controls the underlying asset before the lease commencement date, the lessee would apply the sale and leaseback provisions of the new standard.

How we see it

Absent additional guidance, it is not clear how lessees and lessors would determine what, if any, assets to record in certain arrangements (e.g., when leasehold improvements are constructed by or on behalf of the lessee). In many instances, judgment would be required to determine whether the lessee is constructing leasehold improvements or leasing fully built-out space.

Separate requirements for leases involving real estate

ASC 840 requires both lessees and lessors to account for leases involving real estate according to their classification as capital, sales-type, direct financing or operating using their respective criteria. However, certain additional tests are necessary, and the land, building and equipment components of a lease are accounted for separately in some instances. The unique treatment of real estate in lease transactions is consistent with the accounting recognition that real estate is different from equipment by its nature. Just as there are distinct rules for real estate sales transactions (until the effective date of ASC 606 and ASC 610), there are also distinct rules for leases involving real estate and sale and leaseback transactions involving real estate.

How we see it

The elimination of today's real estate-specific guidance, including the restrictions for sale and leaseback transactions, would be a major change. We would generally expect more sale and leaseback transactions involving real estate to be accounted for as sales and subsequent leasebacks under the new standard than under today's guidance. In addition, we would expect more leases of real estate to result in up-front selling profit recognition (i.e., for Type A leases).

Leveraged leases that are not grandfathered upon transition

Leveraged lease arrangements existing at transition would be grandfathered. Thus, we expect the new standard to retain the subsequent measurement guidance for leveraged leases currently in ASC 840.

After transition, entities would apply the new standard to all newly recognized leases, including those that would have been classified as leveraged leases under ASC 840 today. For such leases, entities would apply other relevant US GAAP (e.g., ASC 740, *Income taxes*, ASC 470, *Debt*) to account for the non-lease components of such transactions.

How we see it

It is unclear how modifications or extensions of leveraged leases that are grandfathered would be accounted for under the new standard.

Guidance that may be eliminated pending further FASB discussions

Sale of assets subject to a lease or intended to be leased by the purchaser to a third party

ASC 840 provides guidance for the sale of property subject to an operating lease, or property that is leased or intended to be leased by a third-party purchaser. Such transactions should not be treated as sales when the seller retains substantial risks of ownership, unless the seller is able to determine that the buyer will lease the asset to a third party under a sales-type or direct financing lease.

How we see it

If the FASB eliminates this guidance, we would generally expect lessors to look to the new revenue recognition standard (i.e., ASC 606) or ASC 610-20, *Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets*, to determine whether a sale has occurred.

Lessee maintenance deposits

Under certain lease arrangements, a lessee may be contractually or legally responsible for repair and maintenance of the leased asset during the term of the lease arrangement. In addition, the lease arrangement may require the lessee to make deposits (also commonly referred to as maintenance reserves or supplemental rent) with the lessor to protect the lessor if the lessee does not properly maintain the leased asset (i.e., the lessor would use the funds to restore the leased asset to proper working order).

Under a typical maintenance deposit lease arrangement, the lessor is contractually required to reimburse the lessee a portion of the deposit as qualifying maintenance activities are performed and paid for by the lessee. If the deposits paid to the lessor exceed the costs incurred for maintenance activities, certain lease arrangements state that the lessor is entitled to retain such excess amounts at the expiration of the lease arrangements, whereas other lease arrangements require the lessor to refund such excess amounts to the lessee.

Today, ASC 840 provides guidance for maintenance deposits that are paid by the lessee and refunded only if the lessee performs specified maintenance activities. Such arrangements should be considered deposit assets (by the lessee) if it is probable that the deposits will be refunded. The cost of maintenance activities should be expensed or capitalized by the lessee, as appropriate, when the underlying maintenance is performed. If the likelihood of a maintenance deposit being refunded to the lessee is less than probable, the deposit should be recognized as additional rent expense. If it is probable at inception of the lease that a portion of the deposits will not be refunded, the lessee should recognize a pro-rata portion of the deposits as expense as they are paid.

The sale of tax benefits associated with a leased asset

Periodically, companies enter into transactions that are, in substance, sales of tax benefits through tax leases. These transactions are commonly referred to as "double-dip" transactions as their objective is to provide to more than one entity a deduction in separate tax jurisdictions (e.g., Switzerland, US). The transaction generally involves the sale of a depreciable asset or an interest in an asset (or through a sales-type lease — commonly referred to as a "head lease") to an investor in a foreign jurisdiction in consideration for cash proceeds and an obligation by the seller to lease back the asset under a capital or operating lease. ASC 840 provides guidance on identifying and accounting for sales of tax benefits.

Accounting for a loss on a sublease

An entity may enter into a sublease that will result in a loss. ASC 840 provides guidance on determining when and how a loss is recorded based the type of sublease (i.e., operating, direct financing or sale-type sublease).

If the FASB does not retain the existing guidance, under the new standard intermediate lessors would assess right-of-use-assets that are subject to a sublease for impairment under the long-lived asset impairment provisions of ASC 360.

Appendix C: Key differences between US GAAP and IFRS (updated July 2015)

	US GAAP (FASB)	IFRS (IASB)
Scope and scope exclusions	The scope of the new standard would not apply to leases of intangible assets.	The scope of the new standard would not apply to lessors' leases of intangible assets. However, lessees of intangible assets could apply the new standard but would not be required to.
Leases of small assets (IFRS-only)	No exemption for leases of small assets.	*For lessees only* — Recognition and measurement exemption for leases of certain low-value assets (i.e., small assets).
Lease modifications (updated July 2015)	The accounting for a modification to a Type A lease that does not result in a separate, new lease, would depend on whether lease classification changes. Refer to the lease modifications section.	The accounting for a modification to a Type A lease that does not result in a separate, new lease, would be in accordance with IFRS 9, *Financial Instruments*.
Portfolio approach	Guidance would be included in the non-authoritative Basis for Conclusions.	Guidance would be included in the authoritative paragraphs of the new standard.
Variable lease payments that depend on an index or rate — lessee reassessment	Reassess only when lease liability is remeasured for other reasons (e.g., due to a change in lease term).	Reassess upon remeasurement of lease liability for other reasons and upon a change in the cash flows resulting from a change in the reference index or rate (i.e., when an adjustment to the lease payments takes effect).
Discount rate — lessees	Accounting policy election for lessees that are not public business entities to use the risk-free rate to determine the present value of lease payments (for all leases).	No accounting policy election for lessees to use the risk-free rate for the initial and subsequent measurement of lease liabilities.
Reassessment of the discount rate (updated July 2015)	Reassess upon a modification to a Type A lease that does not result in a separate, new lease when the modified lease remains a Type A lease (i.e., when lease classification does not change).	No reassessment after lease commencement.
Fair value of the underlying asset	Definition of fair value in ASC 820 would not apply to fair value measurements for the purposes of lease classification and measurement (with certain exceptions).	The measurement and disclosure requirements of IFRS 13, would apply to lease transactions within the scope of the new standard.
Related party leasing transactions	Entities would be required to account for related party leasing transactions on the basis of the legally enforceable terms and conditions of the lease.	No guidance for related party leasing transactions.

<table>
<tr><th></th><th>US GAAP (FASB)</th><th>IFRS (IASB)</th></tr>
<tr><td>Lease classification — lessees</td><td>Leases (with an optional exemption for short-term leases) would be classified as Type A or Type B, and there would be no initial measurement difference between them.

Differences would result in the recognition, measurement and presentation of leases for lessees.</td><td>Leases (with optional exemptions for short-term leases and leases of small assets) would be Type A leases.</td></tr>
<tr><td>Lease classification — lessors</td><td>Leases would be classified as Type A or Type B. However, lessors would consider an additional criterion based on collectibility of lease payments.</td><td>Leases would be classified as Type A or Type B.</td></tr>
<tr><td>Determining whether to defer or recognize selling profit — Type A leases with selling profit</td><td>Recognize initial selling profit in a Type A lease only if lessee obtains control of the underlying asset, as that would be defined in the new standard, and collection of lease payments is probable.</td><td>Recognize initial selling profit for all Type A leases with selling profit.</td></tr>
<tr><td>Reassessment of lease classification — lessors</td><td>Reassess upon a modification to a Type A lease that does not result in a separate, new lease.</td><td>No reassessment after lease commencement.</td></tr>
<tr><td>Purchase of a leased asset by the lessee during the lease term (updated July 2015)</td><td>No gain or loss recognized. The difference between the purchase price and the carrying amount of the lease liability would be recorded as an adjustment to the carrying amount of the asset.</td><td>No guidance for the purchase a leased asset by the lessee during the lease term</td></tr>
<tr><td>Presentation — statement of cash flows — lessees</td><td>Cash paid for interest on Type A leases would be presented within operating activities.</td><td>Cash paid for interest on Type A leases would be presented within operating or financing activities consistent with the entity's policy election under IAS 7, Statement of Cash Flows.</td></tr>
<tr><td>Disclosure — qualitative disclosures — lessees</td><td>Would include a specific list of qualitative disclosure requirements.</td><td>Would not include specific qualitative disclosure requirement.</td></tr>
<tr><td>Disclosure — quantitative disclosures — lessees</td><td colspan="2">• The FASB and IASB differ on specific lessee quantitative disclosure requirements mainly because of differences in the lessee accounting models. For example, the FASB's new standard would require disclosure of Type B lease expense, which is not applicable under the IASB's new standard (under which all leases would be Type A leases).

• The FASB would not require a specific format for lessee quantitative disclosures. However, the IASB would require the disclosures to be made in a tabular format, unless another format is more appropriate, and presented in a single note or separate section of the notes to the financial statements.</td></tr>
<tr><td>Other quantitative and qualitative disclosures — Type A leases — lessors</td><td>Qualitative and quantitative disclosure of significant changes in the residual value component of the net investment.</td><td>Qualitative and quantitative disclosure of significant changes in the net investment.</td></tr>
</table>

<table>
<tr><th></th><th>US GAAP (FASB)</th><th>IFRS (IASB)</th></tr>
<tr><td>Intermediate lessor accounting — classification of a sublease</td><td>For purposes of lease classification, the intermediate lessor would consider the underlying asset the leased asset.</td><td>For purposes of lease classification, the intermediate lessor would consider its right-of-use asset as the leased asset.</td></tr>
<tr><td>Sale and leaseback transactions — determining whether a sale has occurred</td><td>No sale occurs when either:
Leaseback is a Type A lease.
Seller-lessee has a substantive repurchase option.
Fair value (date of exercise) repurchase options for non-specialized assets that are readily available in the marketplace would <u>not</u> preclude a sale (i.e., option would be non-substantive).</td><td>No sale occurs when the seller-lessee has a substantive repurchase option with no further guidance for non-specialized assets that are readily available in the marketplace.

Sale accounting is not prohibited for Type A leasebacks because all leases are classified as Type A leases by lessees.</td></tr>
<tr><td>Sale and leaseback transactions — accounting for gains</td><td>Recognize gain in full.</td><td>Recognition of gain would be limited to the portion related to the residual asset. The remaining gain would be recognized as a reduction to the initial measurement of right-of-use asset, thus reflected as a reduction in amortization of the right-of-use asset over term of the leaseback.</td></tr>
<tr><td>Transition</td><td colspan="2">While the FASB's new standard would prohibit the use of a full retrospective transition approach, the IASB's new standard would permit such an approach.
The FASB would require adoption of its new standard using a modified retrospective transition approach. The IASB would permit such a transition approach. However, the FASB and the IASB would require the modified retrospective approach to be applied differently and would provide different types of transition relief.</td></tr>
</table>

No. 2014-23
28 August 2014

Technical Line

FASB — new guidance

The new revenue recognition standard — real estate

Revenue recognition practices of all real estate entities may be affected by the new standard.

What you need to know

- Real estate entities will need to exercise more judgment when applying the new revenue standard than they do today when measuring and recognizing gains and losses on property sales using ASC 360-20, *Real Estate Sales*.
- Entities that sell real estate subject to the revenue standard will generally be able to recognize revenue and associated profit when control of the property transfers. An evaluation of the buyer's initial and continuing investments or the seller's continuing involvement with the property will no longer be required. However, entities must still assess the collectibility of the transaction price using the principles of the new revenue standard.
- Fees for property management and other services may be recognized differently due to the new requirements to estimate variable consideration and to determine the number of performance obligations contained in the contract.
- The new standard is effective for public entities[1] for fiscal years beginning after 15 December 2016 and for interim periods therein. It is effective for nonpublic entities for fiscal years beginning after 15 December 2017 and interim periods within fiscal years beginning after 15 December 2018.

Overview

Real estate entities will need to evaluate their revenue recognition practices as a result of the new revenue recognition standard jointly issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards). The new revenue recognition standard will supersede virtually all revenue recognition guidance in US GAAP and IFRS, including industry-specific guidance that real estate entities use today.

Building a better working world

The new standard provides guidance for accounting for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to customers (unless those contracts are in the scope of other US GAAP guidance such as the leasing literature).

The standard's consequential amendments provide a new model for measuring and recognizing gains and losses on the sale of certain nonfinancial assets (e.g., property and equipment, including real estate) to noncustomers that are otherwise not in the scope of the new revenue recognition guidance. Accounting for contracts that include the sale of a nonfinancial asset to a noncustomer or a customer generally will be consistent, except for financial statement presentation and disclosure. Entities that sell nonfinancial assets to noncustomers will follow guidance in Accounting Standards Codification (ASC) 360-10 for presenting a gain or loss on the sale of a long-lived asset.

The new revenue recognition model for the sale of real estate differs significantly from the prescriptive rules in ASC 360-20, *Real Estate Sales.* The new principles-based approach is largely based on the transfer of control. As a result, more transactions will likely qualify as sales of real estate, and revenue (i.e., gain on sale) will be recognized sooner than it is under today's accounting.

The accounting for management fees and other fees that vary based on performance (e.g., percentage of the property's revenues or net operating income) will also change. A property manager will have to estimate, at contract inception, the variable consideration to which it will be entitled and for which it is probable that a significant revenue reversal will not occur. This amount will then be recognized in the period as the performance obligation is satisfied.

This publication considers key implications for the real estate industry and provides an overview of the revenue recognition model with a focus on entities that:

- Own, operate and sell real estate assets
- Provide real estate property management services
- Engage in hospitality management activities
- Construct and sell single-family homes and residential developments (e.g., condominiums)

This publication supplements our Technical Line, *A closer look at the new revenue recognition standard* (SCORE No. BB2771), and should be read in conjunction with it.

Real estate entities also may want to monitor the discussions of both the Boards' Joint Transition Resource Group for Revenue Recognition (TRG) and a task force formed by the American Institute of Certified Public Accountants (AICPA) to focus on hospitality and time-sharing issues. The Boards created the TRG to help them determine whether more implementation guidance or education is needed. The TRG won't make formal recommendations to the Boards or issue guidance. The AICPA's hospitality and time-sharing industry task forces are two of 16 industry task forces the AICPA has formed to help develop a new Accounting Guide on Revenue Recognition and to aid industry stakeholders in implementing the standard. Any views discussed by the TRG or guidance produced by the AICPA are non-authoritative.

The views we express in this publication are preliminary. We may identify additional issues as we analyze the standard and entities begin to interpret it, and our views may evolve during that process. As our understanding of the standard evolves, we will issue updated guidance.

Contents

1 Summary of the new model

The new guidance in ASC 606, *Revenue from Contracts with Customers*, outlines the principles an entity must apply to measure and recognize revenue and the related cash flows. The core principle is that an entity will recognize revenue at an amount that reflects the consideration to which it expects to be entitled in exchange for transferring goods or services to a customer.

The principles in the new standard will be applied using the following five steps:

1. Identify the contract(s) with a customer

2. Identify the performance obligations in the contract

3. Determine the transaction price

4. Allocate the transaction price to the performance obligations in the contract

5. Recognize revenue when (or as) the entity satisfies a performance obligation

An entity will need to exercise judgment when considering the terms of the contract(s) and all of the facts and circumstances, including implied contract terms. An entity also will have to apply the requirements of the new standard consistently to contracts with similar characteristics and in similar circumstances.

On both an interim and annual basis, an entity generally will have to provide more disclosures than it does today and include qualitative and quantitative information about its transactions accounted for under the new standard and significant judgments made (and changes in those judgments). On an interim basis, US GAAP will require more disclosure than will be required under IFRS.

Transition and effective date

The new standard is effective for public entities for fiscal years beginning after 15 December 2016 and for interim periods therein. It is effective for nonpublic entities for fiscal years beginning after 15 December 2017 and interim periods within fiscal years beginning after 15 December 2018, and they may elect to adopt the guidance as early as the public entity effective date. Under US GAAP, early adoption is prohibited for public entities.

All entities will be required to apply the standard retrospectively, either using a full retrospective or a modified retrospective approach. The Boards provided certain practical expedients to make it easier for entities to use a full retrospective approach.

Under the modified retrospective approach, financial statements will be prepared for the year of adoption using the new standard, but prior periods won't be adjusted. Instead, an entity will recognize a cumulative catch-up adjustment to the opening balance of retained earnings (or other appropriate component of equity or net assets) at the date of initial application for contracts that still require performance by the entity (i.e., contracts that are not completed). Entities will need to provide certain disclosures in the year of adoption, such as the amount by which each financial statement line item is affected as a result of applying the new standard.

How we see it

Entities that are recognizing profit from the sale of a real estate property using one of the alternative recognition methods in ASC 360-20 (e.g., installment method, cost recovery method, deposit method) will need to carefully evaluate the transition approaches in the new standard.

Entities with deferred revenue balances or failed sales from real estate sales that predate their adoption of the new standard may experience "lost revenue." That's because the deferred amounts or previously unrecognized sales will be reflected in the recasted prior periods (under the full retrospective approach) or as part of the cumulative effect adjustment upon adoption (under the modified retrospective approach), but never reported as revenue in a current period within the financial statements.

The illustration below compares the application of the two transition approaches to a real estate sale for which profit was previously deferred under the installment method. Real estate entities that have previously deferred profit from a sale under another method in ASC 360-20 will need to consider specific transition issues that may arise from each respective method (e.g., interest expense and/or continued depreciation of the property under any of the financing, leasing, profit-sharing or deposit methods).

Illustration 1-1: Comparison of transition approaches

Developer A, a public entity with a 31 December fiscal year-end, sold a real estate property with a carrying value of $6 million for net proceeds of $11 million. The sale closed on 31 December 2014 but did not qualify for full accrual profit recognition because the terms of the four-year note receivable (i.e., seller financing) provided by Developer A did not meet the initial and continuing investment criteria in ASC 360-20. Under ASC 360-20, Developer A applied the installment method and determined that $1 million of profit should be recognized at the sale date, $1 million in 2015, $1 million in 2016, and $2 million in 2017 when the initial and continuing investment criteria were expected to be satisfied. Developer A will also recognize interest income from the note as it is received.

The new revenue standard is effective for Developer A for interim and annual periods beginning 1 January 2017. Management evaluates the new revenue standard and concludes that the terms of the seller financing would not have precluded the recognition of the $5 million of profit at the date of sale.

Full retrospective approach

Developer A presents three years of comparative financial information in its 2017 annual filings with the Securities and Exchange Commission (SEC). In accordance with ASC 250,[2] the full $5 million of profit from the sale that occurred on 31 December 2014 would be recorded as a cumulative catch-up to retained earnings as of 1 January 2015 in the recasted financial information. Deferred profit of $1 million that was previously recognized in both 2015 and 2016 would no longer be included in the income statements of each respective period.

Quarterly SEC filings of Developer A will also reflect this presentation beginning 31 March 2017.

Modified retrospective approach

The sale of the property by Developer A constitutes a completed contract as defined in the new standard[3] because control of all goods (i.e., the property) was transferred on 31 December 2014, before the date of initial application by the entity. Under the modified retrospective approach, the new standard is only applied to contracts that are in progress at the date of initial application (i.e., 1 January 2017). Therefore, Developer A would recognize the remaining $2 million of deferred revenue at 1 January 2017 as a cumulative catch-up to retained earnings at the beginning of the period. In contrast to what happens when the full retrospective approach is used, the $1 million of deferred revenue recognized in both 2015 and 2016 continues to be reflected in each respective comparative period.

Developer A also must disclose the $2 million of profit that would have been recognized in 2017 had ASC 360-20 remained in effect.

2 Scope

ASC 606 applies to all contracts with customers to provide goods or services in the ordinary course of business, except for contracts that are specifically excluded from the scope, which include:

- Lease contracts within the scope of ASC 840, *Leases*
- Insurance contracts with the scope of ASC 944, *Financial Services — Insurance*
- Financial instruments and other contractual rights or obligations (e.g., receivables, debt and equity securities, derivatives)[4]
- Guarantees (other than product or service warranties) within the scope of ASC 460, *Guarantees*
- Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange within the scope of ASC 845, *Nonmonetary Transactions*

Entities may enter into transactions that are partially within the scope of the new revenue recognition guidance and partially within the scope of other guidance. In these situations, the new guidance requires an entity to first apply any separation and/or measurement principles in the other guidance before applying the revenue standard.

For example, in certain transactions, the seller of a real estate property may agree to support the operations of the property for a period of time or provide a guarantee of the buyer's return on investment. Under today's guidance, because these guarantees either prevent the guarantor from being able to account for the transaction as a sale or recognize in earnings the profit from the sale, these "seller support" guarantees are excluded from the scope of ASC 460 and are instead accounted for using ASC 360-20.

Under the new standard, the presence of the guarantee does not, on its own, affect whether an entity can recognize a sale and the associated profit from the transfer of the property. Instead, the fair value of the guarantee will first be separated from the transaction price and recorded as a liability in accordance with ASC 460[5]. The remainder of the estimated arrangement consideration is allocated among the other elements in the arrangement (e.g., other performance obligations, including the transfer of the asset). The entity then evaluates whether the other performance obligations have been satisfied without considering the guarantee.

In addition, the new standard may affect arrangements involving leases. While ASC 840 provides guidance on allocating an arrangement's consideration between a lease and lease-related executory costs, this guidance refers to ASC 606 for direction on allocating the total consideration between the deliverables subject to ASC 840 and those that are not within the scope of ASC 840. Accordingly, the estimated transaction price should be allocated between the deliverables within the scope of ASC 840 and any deliverables within the scope of the revenue guidance based on the relative standalone selling price of each deliverable (see Chapter 6).

How we see it

In its recent redeliberations of the proposed leases standard,[6] the FASB tentatively concluded that lessors would be required to apply the new revenue standard to allocate contract consideration between the lease and non-lease components of a contract.

The FASB staff also indicated that activities and costs, such as a lessor's promise to provide services (e.g., common area maintenance or CAM) or pay for utilities consumed by the lessee, would represent non-lease components. If this tentative decision is reflected in any final leasing standard, revenue from these non-lease components will be recognized in accordance with the new revenue standard.

2.1 Contracts with customers

The new revenue guidance defines a customer as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." The standard does not define the term "ordinary activities" because it was derived from existing guidance. Under today's guidance, CON 6[7] refers to ordinary activities as an entity's "ongoing major or central operations."

Property management services provided by real estate investment trusts (REITs) and companies in the hotel and hospitality industry are examples of services that are the output of an entity's ordinary activities. In addition, the sale of a home by a homebuilder or a residential condominium unit by a real estate developer would also represent ordinary activities.

In contrast, an entity that sells a commercial property that it had used as its corporate headquarters to a real estate entity would likely conclude that its decision to dispose of that asset is not an output of its ordinary activities and, therefore, does not represent a contract with a customer. However, as described in Section 2.2 below, the FASB also added derecognition guidance in its consequential amendments for the sale of nonfinancial assets and in substance nonfinancial assets (e.g., a legal entity that primarily holds nonfinancial assets) that are not the output of an entity's ordinary activities.

2.2 Sales of nonfinancial assets (including in substance nonfinancial assets)

Judgment will be required when determining whether to apply ASC 606, ASC 610-20 or ASC 810-10 to sales of real estate.

Nonfinancial assets are often sold in transactions that would not represent a contract with a customer because the sale of the asset is not an output of the entity's ordinary activities (e.g., the sale of a former corporate headquarters building by an electronics manufacturer). The Boards noted in the Basis for Conclusions[8] in the new standard that there is economically little difference between the sale of real estate that is, or is not, an output of the entity's ordinary activities and that the only difference in the accounting for these transactions should be the presentation in the statement of comprehensive income (i.e., revenue and expense when the sale is to a customer or gain or loss when the sale is to a noncustomer).

The FASB amended ASC 360-10, *Property, Plant, and Equipment*, to provide direction on applying the appropriate guidance when derecognizing a nonfinancial asset (e.g., real estate). The amended guidance states that sales of nonfinancial assets, including in substance nonfinancial assets, should be accounted for using new guidance in ASC 610-20, *Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets*, unless the contract is with a customer (i.e., a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration). If the contract is with a customer, ASC 606 will apply. However, ASC 610-20 does not contain incremental guidance to ASC 606 but rather instructs entities to apply certain control and measurement guidance from ASC 606, including guidance related to:

- Evaluating the existence of a contract (see Chapter 3)
- Measuring the consideration (i.e., determining the transaction price) in the contract (see Chapter 5)
- Determining when control of the nonfinancial asset has transferred (i.e., when a performance obligation is satisfied) (see Chapter 7)

Accounting for contracts that include the sale of a nonfinancial asset to a noncustomer or a customer generally will be consistent, except for financial statement presentation and disclosure. Entities that sell nonfinancial assets to noncustomers will follow guidance in ASC 360-10 for presenting a gain or loss on the sale of a long-lived asset.

The amended guidance in ASC 360-10 also indicates that there may be certain circumstances in which neither ASC 606 nor ASC 610-20 are applied when derecognizing a nonfinancial asset. The sale (deconsolidation) of real estate in a subsidiary or group of assets to noncustomers that meets both of the following requirements is accounted for in accordance with the derecognition guidance in ASC 810, *Consolidation:*

- It is a business
- It is not also an in substance nonfinancial asset (because the group of assets or subsidiary also contains significant financial assets)

It is important to note that, if both criteria are met, ASC 810 is applied whether or not the assets transferred are in a legal entity. The following table summarizes the application of the appropriate derecognition guidance for common real estate sales transactions:

ASC topic	When applied?	Possible transactions
ASC 606	Sales of real estate (i.e., nonfinancial assets or in substance nonfinancial assets, regardless of whether they also meet the definition of a "business") to customers	Sales of residences by homebuilders and real estate developers
ASC 610-20	Sales of real estate (i.e., nonfinancial assets or in substance nonfinancial assets, regardless of whether they also meet the definition of a "business") to noncustomers	Sales of commercial properties (e.g., office buildings, hotels, manufacturing facilities) by REITs, real estate funds and non-real estate entities
ASC 810-10	Sale (deconsolidation) of real estate in a subsidiary or group of assets that constitutes a "business" and is composed of both substantial financial and nonfinancial assets to noncustomers	Sales by any entity of real estate and substantial financial assets that together are a "business"

How we see it

The FASB did not define an "in substance nonfinancial asset" in the consequential amendments. As a result, entities may consider making judgments similar to those they make today when determining whether a group of assets or subsidiary is "in substance real estate" under ASC 360-20.[9]

An entity that derecognizes a subsidiary or group of assets that meet the definition of a business will need to exercise significant judgment to determine whether the transaction also constitutes the transfer of an in substance nonfinancial asset that will be subject to the guidance in ASC 610-20 rather than ASC 810-10.

The FASB currently has a project[10] on its agenda to clarify the definition of a business. In this project, it also hopes to clarify the accounting for the acquisition or disposal of an in substance nonfinancial asset. The timing and outcome of this project are unclear.

2.3 Sale-leaseback transactions

While the FASB made it clear that ASC 360-20 should no longer be applied to sales and transfers of real estate, the guidance on sale-leaseback transactions involving real estate that are within the scope of ASC 840-40, *Sale-Leaseback Transactions,* was retained. A number of amendments were made to narrow the scope of ASC 360-20, and the FASB specifically stated[11] that entities should not analogize to the retained guidance when evaluating any transaction that is not a sale-leaseback.

The Boards' current joint project on leases is expected to provide new guidance for sale-leaseback transactions that will eventually replace the guidance in ASC 360-20 and ASC 840-40. However, the timing of a new leases standard is unclear.

2.4 Nonmonetary transactions

As discussed in Section 5.3, the new standard provides guidance for contracts with customers involving the exchange of nonmonetary consideration. As a result, the FASB has excluded contracts that fall within the guidance of ASC 606 and ASC 610 from the scope of ASC 845. The specific guidance in ASC 845 for exchanges of real estate involving monetary consideration also has been eliminated. The FASB clarified that the exchange of a nonfinancial asset (including an in substance nonfinancial asset) for a noncontrolling ownership interest in the receiving entity is within the scope of ASC 845.

3 Identify the contract with the customer

To apply the new revenue guidance, an entity must first identify the contract, or contracts, to provide goods and services to customers. Such contracts may be written, oral or implied by the entity's customary business practice but must be enforceable by law and meet specified criteria. These criteria include approval of the contract by all parties and their commitment to perform their respective obligations, the ability to identify each party's rights regarding goods and services to be transferred and the associated payment terms, and whether the contract has commercial substance.

In addition, before an arrangement with a customer is considered a contract in the scope of the new revenue guidance, an entity must conclude that it is probable that it will collect the transaction price. The transaction price is the amount to which the entity expects to be entitled in exchange for the goods or services that will be transferred to the customer as opposed to the contract price. The term "probable" is defined as "the future event or events are likely to occur," consistent with the definition in ASC 450, *Contingencies*. To assess collectibility, an entity should evaluate the customer's ability and intent to pay the transaction price when due.

The prescriptive guidance in ASC 360-20 for evaluating a buyer's initial and continuing investment has been replaced by the collectibility assessment in the new standard.

The transaction price may be less than the stated contract price if an entity concludes that it has offered or is willing to accept a price concession or other discount. Such concessions or discounts are forms of variable consideration (see Section 5.2) that an entity would estimate at contract inception and reduce from the contract price to derive the transaction price. The estimated transaction price would then be evaluated for collectibility. The following table illustrates these concepts:

Stated contract price	$ 2,000,000
Price concession - amount entity estimates it will offer or accept as a reduction to the contractual price	($200,000)
Transaction price	$ 1,800,000

How we see it

In most real estate arrangements, a signed, written contract specifies the asset to be transferred or management services to be provided in exchange for a defined payment. This generally will result in a straightforward assessment of most of the contract criteria.

However, entities that sell real estate and provide financing to the buyer may find that more judgment is required to evaluate the collectibility of the transaction price. These entities may be used to applying the strict quantitative criteria in ASC 360-20 for determining whether a buyer's initial and continuing investment is sufficient to allow for sale and profit recognition, which has been eliminated. In contrast, there is little guidance in the new standard to help entities determine whether the terms of seller-provided financing, and the borrower's ability to fulfil those terms, still allow the collectibility threshold to be met.

The new standard provides guidance for entities to follow when an arrangement does not meet the criteria of a contract.

3.1 Contract modifications

A contract is modified when there is a change in the scope or price (or both). Changes to existing contracts, such as change orders or upgrades during the construction of a home or condominium, are examples of contract modifications.

An entity must determine whether the modification should be accounted for as a separate new contract or as part of the existing contract. Two criteria must be met for a modification to be treated as a separate new contract: (1) the additional goods and services are distinct from the goods and services in the original arrangement and (2) the amount of consideration expected for the added goods and services reflects the standalone selling price of those goods or services. In this respect, only modifications that *add* distinct goods and services to the arrangement can be treated as separate new contracts. In determining the standalone selling price for the new contract, entities have some flexibility, depending on the facts and circumstances.

Only contract modifications that add distinct goods or services can be treated as separate contracts.

A contract modification that does not meet the criteria to be accounted for as a separate new contract is considered a change to the original contract and is treated as either the termination of the original contract and the creation of a new contract or as a continuation of the original contract, depending on whether the goods or services to be provided after the contract modification are distinct. A modification is accounted for on a prospective basis (i.e., as a termination of the original contract and creation of a new contract) if the goods and services to be provided as a result of the modification are distinct from the goods and services in the original contract, but the consideration does not reflect the standalone selling price of the new goods or services. The remaining consideration is allocated to the remaining performance obligations. An entity should account for a modification as a continuation of the original contract if the remaining goods or services to be provided are not distinct from the goods and services already provided and therefore, form part of a single performance obligation that is partially satisfied at the date of the modification. Such modifications are accounted for on a cumulative catch-up basis. See Chapter 4 for further discussion of identifying performance obligations in the contract.

4 Identify the performance obligations in the contract

After identifying the contract, an entity will evaluate the contract terms and its customary business practices to identify all promised goods or services within the contract and determine which of those promised goods or services (or bundle of promised goods or services) should be accounted for as separate performance obligations (i.e., the unit of account for purposes of applying the standard). The revenue standard identifies several activities common to real estate entities that are considered promised goods and services, including the sale of goods produced or resale of goods purchased (e.g., real estate properties); the performance of a contractually agreed-upon task for a customer (e.g., property management); and the construction, manufacture or development of an asset on behalf of a customer.

Promised goods and services represent a performance obligation if (1) the goods or services are distinct (by themselves or as part of a bundle of goods and services) or (2) if the goods and services are part of a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer.

4.1 Determination of distinct

The new standard outlines a two-step process for determining whether a promised good or service (or a bundle of goods and services) is distinct:

- Consideration at the level of the individual good or service (i.e., the goods or services are capable of being distinct)
- Consideration of whether the good or service is separately identifiable from other promises in the contract (i.e., the good or service is distinct within the context of the contract)

Both of these criteria must be met to conclude that the good or service is distinct. When the criteria are met, the individual units of account must be separated.

In many cases, goods or services are capable of being distinct but may not be distinct within the context of the contract. The standard provides factors to determine whether goods or services are not separately identifiable and should be combined as one performance obligation (i.e., they are not distinct in the context of the contract). These factors, if present, would indicate that goods and/or services should be combined:

- The entity integrates the good or service with other goods or services promised in the contract into a bundle that represents the combined output described in the contract.
- The good or service significantly modifies or customizes another good or service promised in the contract.
- The good or service is highly dependent on, or highly interrelated with, other goods or services promised in the contract.

If an entity determines that the promised good or service does not meet both criteria (i.e., capable of being distinct and distinct within the context of the contract), and thus is not distinct, the entity has to combine that good or service with other promised goods or services until a distinct bundle is formed. This distinct bundle is accounted for as a single performance obligation, illustrated in the following example:

Illustration 4-1: Construction of a residential home

Homebuilder B enters into a contract to build a new home for a customer on land owned by Homebuilder B. Ownership of the home and land are transferred to the customer when construction is completed. The homebuilder is responsible for the overall management of the project and identifies various goods and services to be provided, including design work, procurement of materials, site preparation and foundation pouring, framing and drywall, mechanical and electrical work, installation of fixtures (e.g., windows, doors, cabinetry) and finishing work.

Analysis: Homebuilder B first evaluates whether the customer can benefit from each of the various goods and services either on their own or together with other readily available resources. Homebuilder B determines that these goods and services are regularly sold separately to other customers by other contractors. Therefore, the customer could generate economic benefit from each of the goods and services either on their own or together with the other goods and services that are readily available to the customer, although they would have to be provided in the context of a different property. Consequently, Homebuilder B determines that the goods and services are capable of being distinct.

Homebuilder B then evaluates whether the goods and services are distinct within the context of the contract. Homebuilder B determines that the contract requires that it provide a significant service of integrating the various goods and services (the inputs) into the new home (the combined output). Therefore, Homebuilder B's promise to transfer the various individual goods and services in the contract are not separately identifiable from other promises in the contract. That is, the various goods and services are all conveyed via a completed home.

Because both criteria for identifying a distinct good or service are not met, Homebuilder B determines the goods and services are not distinct and accounts for all of the goods and services in the contract as a single performance obligation. See Chapter 7 for discussion of satisfaction of performance obligations.

It is unclear how amenities provided by a homebuilder or residential condominium developer will be accounted for under the new guidance. Often, amenities are sold or transferred in connection with the sale of individual units of a real estate project. In evaluating these transactions, entities should consider:

- The parties involved (e.g., customer and homeowner's association)
- Whether separate performance obligations exist and what they are (e.g., goods or services)
- To which parties the promises (potentially performance obligations) are made

How we see it

All real estate entities will need to determine whether separate performance obligations exist within their contracts. We expect these judgments may be more complex for homebuilders, developers of residential condominiums and entities that, in addition to property sales, provide property management services because the nature of these contracts requires the entity to perform multiple activities that may (or may not) represent separate performance obligations.

4.2 Series of distinct goods and services that are substantially the same and that have the same pattern of transfer

As mentioned above, goods and services that are part of a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer must be accounted for as a single performance obligation to that customer if both of the following criteria are met:

- Each distinct good or service in the series that the entity promises to transfer consecutively represents a performance obligation that would be satisfied over time (see Section 7.1) if it were accounted for separately.
- The entity would measure its progress toward satisfaction of the performance obligation using the same measure of progress for each distinct good or service in the series (see Section 7.1.4).

Property management services (e.g., maintenance, janitorial, leasing, back office), would likely meet both criteria. However, because property management service contracts are usually composed of multiple underlying activities, significant judgment may be required to determine which activities within a services contract would meet both criteria. The following illustrates how a real estate entity might evaluate performance obligations in a property management contract:

Entities that provide property management services will need to determine which activities comprise a series of distinct services.

Illustration 4-2: Identifying performance obligations in a property management contract

Operator R enters into a five-year contract with Owner S to provide property management services for a regional mall. The contract stipulates that Operator R will perform the following functions:

- Manage day-to-day operations of the mall for a fee of 5% of the property's quarterly lease revenues
- Provide leasing services for a fee of $5 per square foot for new lease agreements and $3 per square foot for renewal lease agreements

Operator R evaluates each of the services provided in the contract to identify whether separate performance obligations are present. Operator R also considers the underlying activities that comprise each of the services to determine whether they meet the criteria to be accounted for as a single performance obligation (or whether the service may be several performance obligations).

Operator R also determines that the leasing services are distinct from the management services (i.e., the leasing and management services are not combined to form a single performance obligation). Both services are capable of being distinct and are distinct in the context of the contract because the services are not highly interrelated with one another. The activities that are necessary to perform the day-to-day management of the property are independent of those that are required to negotiate and execute leases with tenants.

Analysis of management services

Operator R first evaluates the activities that must be performed in order to manage the day-to-day operations of the property. Operator R identifies a number of activities that comprise the overall property management services, including maintenance, janitorial, security, landscaping, snow removal, tenant relationship management and back office support. While each of these activities are individually capable of being distinct, Operator R concludes that they are not distinct within the context of the contract because the ultimate objective of the management services is to perform any activities that are necessary to ensure the property is open and operating as intended.

In addition, Operator R determines that the management services represent a series of services that are substantially the same and have the same pattern of transfer to Owner S. While the specific activities that occur each day may vary slightly (e.g., landscaping may occur in the summer while snow removal occurs in the winter), the overall service of property management is substantially the same and has the same pattern of transfer (i.e., transfers daily) over the term of the contract. Further, each distinct service represents a performance obligation that would be satisfied over time (i.e., over the length of the contract, not at a point in time) and has the same measure of progress (e.g., time elapsed), thereby meeting the stated criteria.

Analysis of leasing services

Operator R then evaluates the activities that comprise the leasing services. Operator R identifies several activities that occur throughout the leasing process, including monitoring of upcoming vacancies, new tenant identification, proposal preparation, lease negotiation and document preparation. While certain of these activities may be capable of being distinct (i.e., document preparation could be outsourced), Operator R concludes they are not distinct within the context of the contract because the ultimate objective of the leasing services is to execute individual leases with tenants to maintain the overall occupancy of the property.

Operator R will need to define the leasing performance obligation by determining whether the leasing services are a single performance obligation or a number of performance obligations (i.e., the execution of each lease).

How we see it

As illustrated above, entities will need to first determine which services in the contract are distinct and therefore could represent separate performance obligations. Then, these services will need to be evaluated to determine whether they are substantially the same, have the same pattern of transfer and meet the two criteria discussed above and therefore must be combined into one performance obligation. This evaluation may require significant judgment when a property manager performs activities beyond day-to-day operation of the property.

For example, a retail property manager may be responsible for identifying and executing leases with seasonal tenants, attracting on-site events (e.g., automobile tent sales) or placing advertising or promotional signage around the property. If an entity determines that these activities represent separate performance obligations, and the contract does not specify separate revenues that reflect the standalone selling prices of these services, the base management fee must be allocated to each separate performance obligation (see Chapter 6).

5 Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. The entitled amount is meant to reflect the amount that the entity has rights to under the present contract and may differ from the contractual price (e.g., if the entity expects or intends to offer a price concession).

The consideration promised in a contract may include fixed or variable amounts. When determining the transaction price, entities must estimate the variable consideration expected to be received. The requirement to estimate variable consideration at contract inception in property management contracts and certain real estate sales agreements may represent a significant change for real estate entities. The transaction price also will include the fair value of any noncash consideration, the effect of a significant financing component (i.e., the time value of money) and the effect of any consideration payable to a customer.

5.1 Variable consideration

The transaction price may vary in amount and timing as a result of discounts, credits, price concessions, incentives or bonuses. In addition, consideration may be contingent on the occurrence or nonoccurrence of a future event or earned as a percentage of an underlying measure (e.g., sales, profits, operating performance).

An entity is required to estimate variable consideration using either the "expected value" approach (i.e., the sum of probability-weighted amounts) or the "most likely amount" approach (i.e., the single most likely outcome), whichever better predicts the amount of consideration to which it will be entitled. That is, the method selected is not meant to be a "free choice." The entity should apply the selected method consistently throughout the contract and update the estimated transaction price at each reporting date.

The Boards indicated[12] that the most likely amount approach may be the better predictor when the entity expects to be entitled to only one of two possible amounts (e.g., a contract in which an entity is entitled to receive all or none of a specified performance bonus but not a portion of that bonus). The following provides an illustration of a real estate entity estimating variable consideration resulting from future profit participation from a sale of real estate.

Illustration 5-1: Estimating variable consideration

Developer D sells a newly constructed commercial property with a cost basis of $1.9 million for $2 million, plus a right to receive 5% of future operating profit from the property for the first year. Developer D has no additional ongoing performance obligations. Developer D determines there are a number of possible outcomes of consideration to be received based on the performance of the property (i.e., the buyer's ability to secure tenants for the entire property at favorable rental rates). The buyer currently has executed leases or letters of intent from prospective tenants for 50% of the property.

Analysis: Developer D has to determine whether the "expected value" or "most likely amount" approach better predicts the variable consideration to be received. Developer D determines that the "expected value" approach is the better predictor of the variable consideration since multiple outcomes are possible.

Based on the buyer's current pre-leasing, Developer D estimates the following future profit participation:

Future profit	Probability
$ 50,000	10%
$ 25,000	70%
$ 0	20%

Assume for purposes of this illustration that the constraint, discussed further below, does not limit the amount that can be included in the transaction price at contract inception (i.e., assume it is probable that a significant revenue reversal will not occur). Using a probability-weighted estimate, Entity A would include $22,500 [($50,000 x 10%) + ($25,000 x 70%) + ($0 x 20%)] in the transaction price associated with this variable consideration. That is, the transaction price would be $2,022,500.

Developer D updates its estimate of the transaction price at the next reporting date, and after considering that the buyer now has letters of intent or executed leases for 75% of the property, determines it is now 75% likely to receive future profit participation of $50,000 and 25% likely to receive $25,000. As a result, Developer D's estimate of variable consideration is updated to $43,750 [($50,000 x 75%) + ($25,000 x 25%)] and additional revenue (i.e., gain on sale) of $21,250 ($2,043,750 — $2,022,500) is recognized.

5.1.1 *Constraining estimates of variable consideration*

The constraint may be applied to variable consideration resulting from the sale of real estate or property management arrangements.

To include variable consideration in the estimated transaction price, the entity has to first conclude that it is "probable" that a significant revenue reversal will not occur when the uncertainties related to the variability are resolved. For purposes of this analysis, "probable" is defined as "the future event or events are likely to occur," consistent with the existing definition in US GAAP. The Boards provided factors that may indicate that revenue is subject to a significant reversal:

- The amount of consideration is highly susceptible to factors outside the entity's influence (e.g., market volatility, judgment or actions of third parties, weather conditions).
- The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
- The entity's experience (or other evidence) with similar types of contracts is limited or that experience (or other evidence) has limited predictive value.
- The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- The contract has a large number and broad range of possible consideration amounts.

The indicators provided by the Boards are not meant to be an all-inclusive list, and entities may note additional factors that are relevant in their evaluations. In addition, the presence of any one of these indicators does not necessarily mean that it is probable that a change in the estimate of variable consideration will result in a significant revenue reversal.

For example, when determining how the constraint affects the estimate of variable consideration, sellers of real estate and property managers will need to consider a variety of factors, including their experiences with similar arrangements, uncertainties that may exist in the latter years of a long-term contract, and market and other factors that may be outside of their control. All entities will want to make sure they sufficiently and contemporaneously document the reasons (including supporting and non-supporting evidence considered) for their conclusions.

When an entity is unable to conclude that it is probable that a change in the estimate of variable consideration that *would* result in a significant revenue reversal will not occur, the amount of variable consideration is limited. In addition, when an arrangement includes variable consideration, an entity should update both its estimate of the transaction price and its evaluation of the constraint throughout the term of the contract to depict conditions that exist at each reporting date.

The following provides an illustration of the application of the constraint to the estimation of variable consideration:

Illustration 5-2: Evaluating the constraint

Assume the same facts as in Illustration 5-1 except that the buyer of the property has just begun negotiations with prospective tenants and has not signed lease agreements for a significant amount of space.

Analysis: Developer D uses the "expected value" approach and estimates it is 25% likely to receive future profit participation of $50,000, 50% likely to receive $25,000 and 25% likely to receive none. Using a probability-weighted estimate (prior to considering the constraint), Entity A would include $25,000 [($50,000 x 25%) + ($25,000 x 50%) + ($0 x 25%)] in the transaction price associated with this variable consideration. That is, the transaction price would be $2,025,000. Because the constraint would be set at $25,000 (i.e., the amount for which it's probable that a significant reversal will not occur), the full $25,000 may be recognized.

How we see it

While the Boards noted in the Basis for Conclusions[13] that entities should evaluate the magnitude of a potential revenue reversal relative to total consideration (i.e., fixed and variable), the Boards did not include any quantitative guidance for evaluating the significance of the amount. This will require entities to use significant judgment when making this assessment.

5.2 Price concessions

As discussed in Chapter 3, before determining that a contract is in the scope of the new standard, an entity has to assess whether it is probable that it will collect the consideration to which it expects to be entitled in exchange for transferring goods or services (i.e., the transaction price). When determining the transaction price, an entity must evaluate its intention or willingness at the outset of the contract to accept less than the stated contract price (i.e., offer or accept a price concession). A price concession is a form of variable consideration and, as such, must be considered when estimating the amount an entity expects to receive under the contract.

5.3 Noncash consideration

The new standard specifies that when an entity receives, or expects to receive, noncash consideration (e.g., in the form of goods or services), the fair value of the noncash consideration (measured in accordance with ASC 820, *Fair Value Measurement)* is included in the transaction price. If an entity cannot reasonably estimate the fair value of the noncash consideration, it should measure the noncash consideration indirectly by reference to the estimated standalone selling price of the promised goods or services to the customer.

5.4 Significant financing component

A significant financing component may exist when the receipt of consideration does not match the timing of the transfer of goods or services to the customer (i.e., the consideration is prepaid or is paid well after the services are provided). Entities will not be required to adjust the transaction price for this component if the financing is not significant to the contract. Further, an entity is not required to assess whether the arrangement contains a significant financing component unless the period between the customer's payment and the entity's transfer of the goods or services is greater than one year.

When an entity concludes that a financing component is significant to a contract, it determines the transaction price by discounting the amount of promised consideration. The entity uses the same discount rate that it would use if it were to enter into a separate financing transaction with the customer. The discount rate has to reflect the credit characteristics of the borrower in the arrangement; using a rate explicitly stated in the contract that does not correspond with market terms in a separate financing arrangement would not be acceptable. Subject to certain limitations, the transaction price will need to be accreted when there is a prepayment that is determined to be a significant financing component.

6 Allocate the transaction price to the performance obligations

Once the separate performance obligations are identified and the transaction price has been determined, the standard generally (with some exceptions) requires an entity to allocate the transaction price to the performance obligations in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis).

To allocate the transaction price on a relative selling price basis, an entity must first determine the standalone selling price (i.e., the price at which an entity would sell a good or service on a standalone basis at contract inception) for each performance obligation. Generally, the observable price of a good or service sold separately provides the best evidence of standalone selling price. However, in many situations, standalone selling prices will not be readily observable. In those cases, the entity has to estimate the standalone selling price.

The standard discusses three estimation methods: (1) an adjusted market assessment approach, (2) an expected cost plus a margin approach and (3) a residual approach, but these are not the only estimation methods permitted. The standard allows an entity to use any reasonable estimation method (or combination of approaches), as long as it is consistent with the notion of a standalone selling price, maximizes the use of observable inputs and is applied on a consistent basis for similar goods and services and customers.

Under ASC 360-20, an entity that sold an asset and retained a management contract at a below market rate was required to use a prevailing rate to "impute" compensation for the management services. The new standard requires the seller to separately estimate the standalone selling prices of the real estate asset and the management services and allocate total consideration received in the contract on a relative basis.

How we see it

Entities that regularly provide third-party management services should already be equipped to make these estimates. However, entities that infrequently provide these services on a standalone basis, but elect to do so in connection with the sale of a real estate asset, may need to develop new processes to estimate the standalone selling price and retain sufficient documentation to support the reasonableness of their calculations.

Under the relative standalone selling price method, once an entity determines the standalone selling price for the performance obligations in an arrangement, the entity allocates the transaction price to those performance obligations based on the proportion of the standalone selling price of each performance obligation to the sum of the standalone selling prices of all of the performance obligations in the arrangement.

6.1 Exceptions to the relative standalone selling price method

The standard requires an entity to use the relative standalone selling price method to allocate the transaction price except in two circumstances. The first exception requires an entity to only allocate a discount in a contract to the specific goods or services to which it relates rather than proportionately to all of the separate performance obligations. To apply this exception, the entity must meet certain criteria[14] that are unlikely to be satisfied in most types of real estate contracts.

Property managers may allocate variable consideration to the period in which the related services were performed, if certain criteria are met.

The second exception requires variable consideration to be allocated entirely to a specific part of a contract, such as one or more (but not all) performance obligations or one or more (but not all) distinct goods or services promised in a series of distinct goods or services that forms part of a single performance obligation, if both of the following criteria are met:

- The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).
- Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the standard's overall objective of allocating revenue in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

In the Basis for Conclusions[15], the Boards discussed an example of a contract to provide hotel management services for one year (i.e., a single performance obligation that is a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer) for which the consideration is variable and based on the operating results of the property. In this example, the variable consideration (e.g., management fees) that relates specifically to an entity's efforts to transfer the services for a certain period within a contract (e.g., a month, a quarter), which are distinct from the services provided in other periods within the contract, are allocated to those distinct periods instead of being spread over the entire performance obligation.

The following illustration depicts the application of this exception by a property manager that determines that the services it is providing represent a single performance obligation:

Illustration 6-1: Property management fees

On 1 January 2018, Operator E enters into a one-year contract with a shopping center owner to provide property management services. Operator E receives a 5% management fee based on the shopping center's quarterly lease revenues, as defined in the agreement. This is a form of variable consideration.

Analysis: Operator E concludes that the management services represent a single performance obligation recognized over time because it determines that it is providing a series of distinct services that are substantially the same and have the same pattern of transfer (i.e., the services transfer to the customer over time and Operator E uses time elapsed to measure progress).

Operator E determines that the transaction price is allocated to each individual quarter because the quarterly management fee relates specifically to the entity's efforts to satisfy the performance obligation during each quarter, and the allocation is consistent with the objective of allocating an amount that depicts the consideration to which the entity expects to be entitled in exchange for transferring the promised services.

For example, if the revenue generated by the property was \$2.0 million in the first quarter of 2018, Operator E would recognize revenue of \$100,000 (\$2.0 million x 5%) at 31 March 2018.

How we see it

Property managers will need to evaluate their contracts to determine whether the exception for allocating variable consideration will apply to contracts that are based on a percentage of the operating results of the underlying property, including contracts that an entity concludes contain only one performance obligation. Some entities will find that applying the exception and therefore recognizing management fees that relate specifically to the entity's efforts to transfer the service in a distinct period is relatively straightforward. However, certain contracts may contain multiple revenue streams that relate to a single performance obligation. For example, in addition to a variable fee, a contract could also include a fixed fee that would generally be recognized over the term of the contract using the entity's selected measure of progress (e.g., time elapsed).

Some property management contracts contain incentive fees that are based on the performance of the underlying property over a different period than the base management fees (e.g., annually versus quarterly). The following illustration depicts the complexity that entities may face and the significant judgment that may be required when recognizing revenues from these arrangements:

Illustration 6-2: Incentive-based fees

Assume the same facts as in Illustration 6-1 except that Operator E also receives a fee of 2% of the property's annual net operating income (NOI). The shopping center has stabilized occupancy, and no significant tenant vacancies are expected during the term of the agreement. The shopping center is located in a region that periodically receives significant snow accumulation from December through May, which results in extensive snow removal costs in certain years.

Analysis: Operator E evaluates variable consideration in the form of the incentive fee. While most of the property's operating costs are predictable, Operator E determines that the variability of snow removal costs can significantly affect NOI of the property. Because of the potential variability in NOI, Operator E uses the "expected value" approach and concludes that there is an equal (33.3%) likelihood of the property generating NOI of $1.2 million, $1.5 million and $1.8 million. Based on this approach, Operator E initially estimates that it will earn $30,000 [.02 x (($1.2 million x 33.3%) + ($1.5 million x 33.3%) + ($1.8 million x 33.3%))] from the incentive fee.

In this scenario, the incentive fee is based on the annual NOI of the property; however, Operator E must determine whether any of the variable consideration should be recognized in the distinct period (i.e., quarter) when the underlying services were performed. Operator E considers whether it is probable that a significant reversal in the incentive fees will not occur prior to the end of the annual period. This assessment requires consideration of the unique facts and circumstances of the arrangement.

Assume Operator E cannot conclude at contract inception that a significant reversal of revenue from the incentive fees is probable to not occur because NOI could be significantly affected by snow removal costs. Snow removal costs result from factors that are beyond its influence (e.g., future weather patterns). Therefore, Operator E applies the constraint to the annual incentive fee and only includes in the allocable transaction price the fees that would be earned from the estimated outcome of NOI for which it is probable that a significant reversal in incentive fees will not occur, or $24,000 ($1,200,000 x .02). Operator E would subsequently update its estimate of the transaction price (and its evaluation of the constraint on variable consideration) at each reporting period.

7 Satisfaction of performance obligations

Under the new standard, an entity recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is considered to be transferred when the customer obtains control. Control of the good or service refers to the ability to direct its use and to obtain substantially all of its remaining benefits (i.e., the right to cash inflows or reduction of cash outflows generated by the good or service). Control also means the ability to prevent other entities from directing the use of and receiving the benefit from a good or service.

The standard indicates that an entity has to determine at contract inception whether it will transfer control of a promised good or service over time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. These concepts are explored further in the following sections.

7.1 Performance obligations satisfied over time

An entity transfers control of a good or service over time (rather than at a point in time) when any of the following criteria are met:

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- The entity's performance creates or enhances an asset (e.g., work in process) that the customer controls as the asset is created or enhanced.
- The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

7.1.1 Customer simultaneously receives and consumes benefits as the entity performs

In some instances, the assessment of whether a customer simultaneously receives and consumes the benefits of an entity's performance will be straightforward (e.g., daily cleaning services for which the simultaneous receipt and consumption by the customer is readily evident). However, in circumstances in which simultaneous receipt and consumption is less evident, the standard clarifies that revenue recognition over time is appropriate if "an entity determines that another entity would not need to substantially reperform the work that the entity completed to date if that other entity were to fulfill the remaining performance obligation to the customer." In making this determination, entities will not consider practical or contractual limitations that limit transfer of the remaining performance obligation.

Real estate entities that provide property management and other services will need to carefully evaluate their contracts to determine whether the services performed are simultaneously received and consumed by the customer (i.e., real estate owner). It may be apparent that services such as routine and recurring maintenance, cleaning and "back-office" functions meet the criteria for recognition of revenue over time. However, determining whether other services, such as leasing or development activities, are simultaneously received and consumed by the real estate owner, or that another entity would not need to substantially reperform activities completed to date, will require significant judgment. These judgments will also be affected by an entity's conclusion about the number of performance obligations (i.e., single or multiple) in the contract (see Chapter 4).

How we see it

As part of its redeliberations of the proposed leases standard, the FASB tentatively decided that services included in leasing contracts (e.g., CAM) may represent non-lease components that will be recognized in accordance with the new revenue standard. Real estate lessors should follow developments in this area as these decisions[6] are tentative and may change before the Boards complete the leases project. Real estate entities may need to consider whether these services are simultaneously received and consumed by their tenants to determine the appropriate recognition method to apply.

7.1.2 Customer controls asset as it is created or enhanced

The second criterion to determine that control of a good or service is transferred over time is that the customer controls the asset as it is being created or enhanced. For example, many construction contracts also contain clauses indicating that the customer owns any work-in-progress as the contracted item is being built.

We plan to discuss the application of this criterion to construction contracts in our upcoming Technical Line, *Revenue recognition — engineering and construction services*.

7.1.3 Asset with no alternative use and right to payment

The laws or legal precedent of a jurisdiction may affect an entity's conclusion of whether a present right to payment is enforceable.

The last criterion to determine that control is transferred over time has the following two requirements that must both be met:

- The entity's performance does not create an asset with alternative use to the entity.
- The entity has an enforceable right to payment for performance completed to date.

Asset with no alternative use

An asset created by an entity has no alternative use if the entity is either restricted contractually or practically from readily directing the asset to another use (e.g., selling to a different customer). An entity has to make this assessment at contract inception and does not update its assessment unless the parties approve a contract modification that substantively changes the performance obligation.

The Boards specified that a contractual restriction on an entity's ability to direct an asset for another use must be substantive (i.e., a buyer could enforce its rights to the promised asset if the entity sought to sell the unit to a different buyer). In contrast, a contractual restriction may not be substantive if the entity could instead sell a different unit to the buyer without breaching the contract or incurring significant additional costs.

Further, a practical limitation exists if an entity would incur significant economic losses to direct the unit for another use. A significant economic loss may arise when significant costs are incurred to redesign or modify a unit or when the unit is sold at a significantly reduced price.

Enforceable right to payment for performance completed to date

An entity has an enforceable right to payment for performance completed to date if, at any time during the contract term, the entity would be entitled to an amount that at least compensates it for work already performed. This right to payment must be present, even in instances in which the buyer can terminate the contract for reasons other than the entity's failure to perform as promised.

To meet this criterion, the amount to which an entity is entitled must approximate the selling price of the goods or services transferred to date, including a reasonable profit margin. Compensation for a reasonable profit margin doesn't have to equal the profit margin expected for complete fulfillment of the contract but must at least reflect either:

- A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination
- A reasonable return on the entity's cost of capital for similar contracts

The standard clarifies[16] that including a payment schedule in a contract does not, by itself, indicate that the entity has the right to payment for performance completed to date. The entity has to examine information that may contradict the payment schedule and may represent the entity's actual right to payment for performance completed to date (e.g., an entity's legal right to continue to perform and enforce payment by the buyer if a contract is terminated without cause).

7.1.4 Measuring progress

When a performance obligation is satisfied over time, the standard provides two methods for measuring progress under the contract: an input method or an output method. While the standard requires an entity to continuously update its estimates related to the measure of progress selected, it does not allow a change in methods. A performance obligation is accounted for under the method the entity selects (i.e., either the input or output method) until it has been fully satisfied.

Under an input method, revenue is recognized "on the basis of the entity's efforts or inputs to satisfy the performance obligation … relative to the total expected inputs to the satisfaction of that performance obligation." The standard includes resources consumed, labor hours expended, costs incurred and time elapsed as possible input methods. The standard also notes it may be appropriate to recognize evenly expended inputs on a straight-line basis.

Under an output method, revenue is recognized "on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract." Measurements of output may include surveys of performance completed to date, appraisals of results achieved, milestones reached and time elapsed.

The standard does not say either method is preferable, but it says an entity should apply the method it selects to similar arrangements in similar circumstances. If an entity does not have a reasonable basis to measure its progress, the Boards decided that too much uncertainty would exist and, therefore, revenue should not be recognized until progress can be measured.

7.2 Control transferred at a point in time

Control is transferred at a point in time if none of the criteria for a good or service to be transferred over time is met. In many situations, the determination of *when* that point in time occurs is relatively straightforward. However, in some circumstances, this determination is more complex.

The Boards provided indicators for entities to consider when determining whether control of a promised asset has been transferred:

- The entity has a present right to payment for the asset.
- The customer has legal title to the asset.
- The entity has transferred physical possession of the asset.

- The customer has the significant risks and rewards of ownership of the asset.
- The customer has accepted the asset.

None of these indicators are meant to be individually determinative. The Boards also clarified that the indicators are not meant to be a checklist, and not all of them must be present to determine that the customer has gained control. An entity has to consider all relevant facts and circumstances to determine whether control has transferred. For example, the presence of a repurchase option in a contract may indicate that the customer has not obtained control of the asset, even though it has physical possession.

How we see it

Entities that sell a real estate asset will generally be able to recognize revenue and associated profit when control of the property transfers (i.e., at a point in time) presuming all other requirements are met. In most real estate transactions, control will transfer when the buyer obtains legal title and physical possession of the asset. Sellers of real estate are no longer required to consider the initial and continuing investment and continuing involvement criteria in ASC 360-20, although they must conclude on the collectibility of the transaction price. Today, real estate sales are often structured to meet the restrictive criteria in ASC 360-20. For example, the criteria create a disincentive for selling a property with 100% seller financing.

8 Other measurement and recognition topics

The new revenue standard includes guidance for licenses and warranties that may result in changes in practice for certain real estate entities. The FASB also issued consequential amendments to ASC 970, *Real Estate — General,* which is commonly applied to real estate transactions.

8.1 Licenses of intellectual property

The standard provides guidance for recognizing revenue from distinct licenses of intellectual property, which includes licenses granted by hospitality entities, that differs slightly from the overall model.

When the license is the only promised item in the contract, the specific license guidance is applicable to that license. However, licenses of intellectual property are frequently included in multiple-element arrangements with promises for additional goods and services that may be explicit or implicit. For example, a hospitality entity may license its brand for use by a hotel owner and also provide marketing and reservation management services. If an entity determines that a license is not distinct from other promised goods or services in the contract, the promise to grant a license and (some or all) of the other promised goods or services should be accounted for as a single performance obligation and the specific guidance for recognizing revenue for distinct licenses is not applied.

For distinct licenses, entities need to determine whether they have provided their customers with either (1) the right to access the entity's intellectual property as it exists throughout the license period, including any changes to that intellectual property (i.e., right to access) or (2) the right to use the entity's intellectual property as it exists at the point in time when the license is granted (i.e., right to use). We generally expect that right-to-use licenses will be uncommon in the real estate industry; thus, the remainder of our discussion focuses on licenses that provide a right to access.

An entity provides the customer a right to access its intellectual property when it is required to undertake activities that significantly affect the licensed intellectual property and the customer is therefore exposed to positive or negative effects resulting from those changes. These activities can be part of an entity's ongoing and ordinary activities and customary business practices (i.e., they do not have to be activities the entity is undertaking specifically as a result of the contract with the customer).

License agreements between hospitality entities and hotel owners generally provide the hotel owner with the right to access the license. Hospitality entities regularly undertake activities that may positively or negatively affect the license and associated brand, rather than directly transfer other goods and services to the customer that should be considered separate performance obligations. Those activities may include analyzing the customer's changing preferences and implementing product and service improvements, pricing strategies, marketing campaigns and operational efficiencies to support the brand name.

The Boards concluded that a license that provides an entity with the right to access intellectual property is satisfied over time "because the customer simultaneously receives and consumes the benefit from the entity's performance of providing access," including the related activities undertaken by entity.

The standard also provides an exception for determining the transaction price when the arrangement includes sales- or usage-based royalties on licenses of intellectual property. The standard requires that this particular type of variable consideration not be included in the estimate of variable consideration, as discussed in Section 5.1. Instead, these amounts are recognized only upon the later of when the subsequent sale or usage occurs or the satisfaction (in whole or in part) of the performance obligation to which some or all of the sales- or usage-based royalty has been allocated.

8.2 Warranties

Warranties are commonly included in arrangements to sell goods or services, whether explicitly stated or implied based on the entity's customary business practices. The new standard identifies two types of warranties.

Warranties that promise the customer that the delivered product is as specified in the contract are called "assurance-type warranties." The Boards concluded that these warranties do not provide an additional good or service to the customer (i.e., they are not separate performance obligations). By providing this type of warranty, the selling entity has effectively provided a quality guarantee. For example, homebuilders and developers of residential condominiums often provide various warranties against construction defects and the failure of certain operating systems for a period of time. Under the standard, the estimated cost of satisfying these warranties is accrued in accordance with the current guidance in ASC 460-10 on guarantees.

Warranties that provide a service to the customer in addition to assurance that the delivered product is as specified in the contract are called "service-type warranties." If the customer has the option to purchase the warranty separately or if the warranty provides a service to the customer beyond fixing defects that existed at the time of sale, the entity is providing a service-type warranty. The Boards determined that this type of warranty represents a distinct service and is a separate performance obligation. Therefore, the entity allocates a portion of the transaction price to the warranty based on the estimated standalone selling price of the warranty. The entity then recognizes revenue allocated to the warranty over the period the warranty service is provided. Service-type warranties are infrequent in the real estate industry.

8.3 Real estate project costs

Today's guidance in ASC 970, *Real Estate — General*, addresses the costs incurred to sell real estate projects (e.g., model units, advertising, sales overhead) and rent real estate projects. It also prescribes the accounting for amenities such as golf courses, clubhouses, swimming pools and parking facilities. The FASB amended the guidance for costs incurred to *sell* real estate projects, and they will be accounted for under the new guidance for costs incurred in obtaining a contract that the FASB added in ASC 340-40, *Other Assets and Deferred Costs — Contracts with Customers*. Costs incurred to *rent* real estate projects and the accounting for amenities will continue to follow the guidance in ASC 970.

The new standard amends the guidance for costs incurred to sell real estate projects.

Under ASC 340-40, incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognized as an asset if the entity expects to recover them. Recovery can be direct (i.e., through reimbursement under the contract) or indirect (i.e., through the margin inherent in the contract). As a practical expedient, the standard permits an entity to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing such costs would have been amortized in one year or less.

The standard cites sales commissions as an example of an incremental cost that may require capitalization. For example, sales commissions that are directly related to sales achieved during a time period would likely represent incremental costs that would require capitalization. In contrast, some bonuses and other compensation that is based on other quantitative or qualitative metrics (e.g., profitability, EPS, performance evaluations) likely do not meet the criteria for capitalization because they are not directly related to obtaining a contract. In addition, costs incurred for model units, advertising and sales overhead may not qualify to be capitalized under ASC 340-40 because they are not incremental costs of obtaining a contract.

ASC 340-40 also includes guidance for recognizing costs incurred in fulfilling a contract that are not in the scope of another topic. For most real estate entities, costs incurred in fulfilling a contract (e.g., the costs to construct a building such as materials and labor) are already within the scope of another topic (e.g., ASC 360, *Plant, Property, and Equipment*) and therefore are excluded from the scope of ASC 340-40. ASC 340-40 also provides guidance on amortization and impairment.

Next steps

Real estate entities should perform a preliminary assessment on how they will be affected as soon as possible so they can determine how to prepare to implement the new standard. While the effect on entities will vary, some may face significant changes in revenue recognition. All entities will need to evaluate the requirements of the new standard and make sure they have processes and systems in place to collect the necessary information to implement the standard, even if their accounting results won't change significantly or at all.

Real estate entities also may want to monitor the discussions of the Boards, SEC staff, the TRG, and hospitality and time-shares industry working groups formed by the AICPA to discuss interpretations and application of the new standard to common transactions. These working groups may address issues that affect all real estate entities.

Public entities also should consider how they communicate the changes caused by the new standard with investors and other stakeholders, including their plan for disclosures about the effects of new accounting standards discussed in SEC Staff Accounting Bulletin (SAB) Topic 11.M. The SEC staff has indicated it expects an entity's disclosures to evolve in each reporting period as more information about the effects of the new standard becomes available, and the entity should disclose its transition method once it selects it.

Endnotes:

[1] The FASB defined public entity for purposes of this standard more broadly than just entities that have publicly traded equity or debt. The standard defines a public entity as one of the following: (1) a public business entity (PBE), (2) a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or (3) an employee benefit plan that files or furnishes financial statements with the SEC.

[2] ASC 250-10-45-5.

[3] ASC 606-10-65-1(c)(2).

[4] This exclusion includes contracts within the scope of the following Topics: ASC 310, *Receivables*; ASC 320, *Investments — Debt and Equity Securities*; ASC 405, *Liabilities*; ASC 470, *Debt*; ASC 815, *Derivatives and Hedging*; ASC 825, *Financial Instruments*; and ASC 860, *Transfers and Servicing*.

[5] Neither ASC 606 nor ASC 460 provides guidance on recognizing revenue associated with a guarantee.

[6] Minutes of the 22 May 2014 FASB Board Meeting.

[7] Statement of Financial Accounting Concepts No. 6, *Elements of financial statements*.

[8] ASU 2014-09, *Basis for Conclusions,* paragraph 497

[9] Refer to Chapter 1 of our Financial reporting developments, *Real Estate Sales*.

[10] Minutes of the 29 May 2013 FASB Board Meeting.

[11] ASU 2014-09, *Consequential Amendments*, paragraph 63

[12] ASC 606-10-32-8

[13] ASU 2014-09, *Basis for Conclusions,* paragraph 217

[14] ASC 606-10-32-37

[15] ASU 2014-09, *Basis for Conclusions,* paragraph 285

[16] ASC 606-10-55-15

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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.

Deloitte.

The new lease accounting standard

How did we get here, anyway?

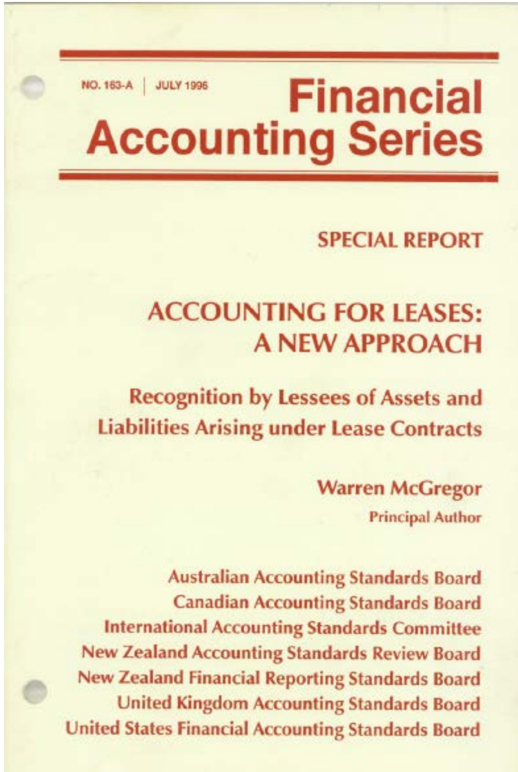
Flawed from the start

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)


NO. 163-A | JULY 1996

Financial Accounting Series

SPECIAL REPORT

ACCOUNTING FOR LEASES: A NEW APPROACH

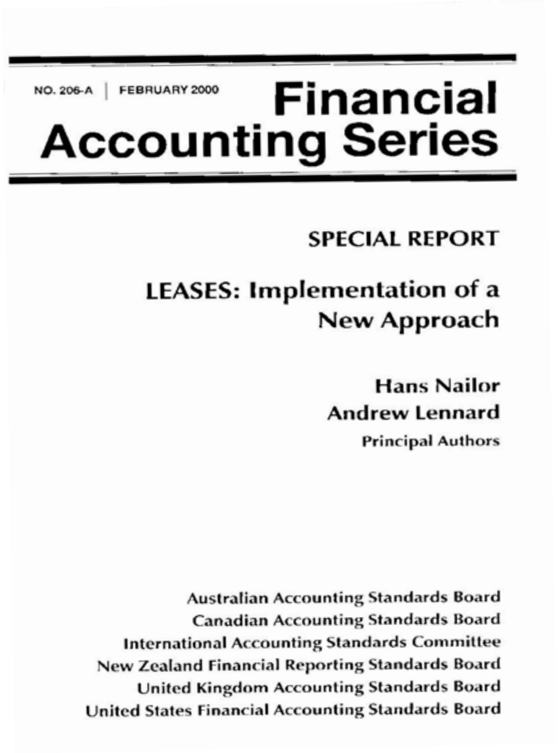
Recognition by Lessees of Assets and Liabilities Arising under Lease Contracts

Warren McGregor
Principal Author

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

"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

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.

loans and other borrowings.

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

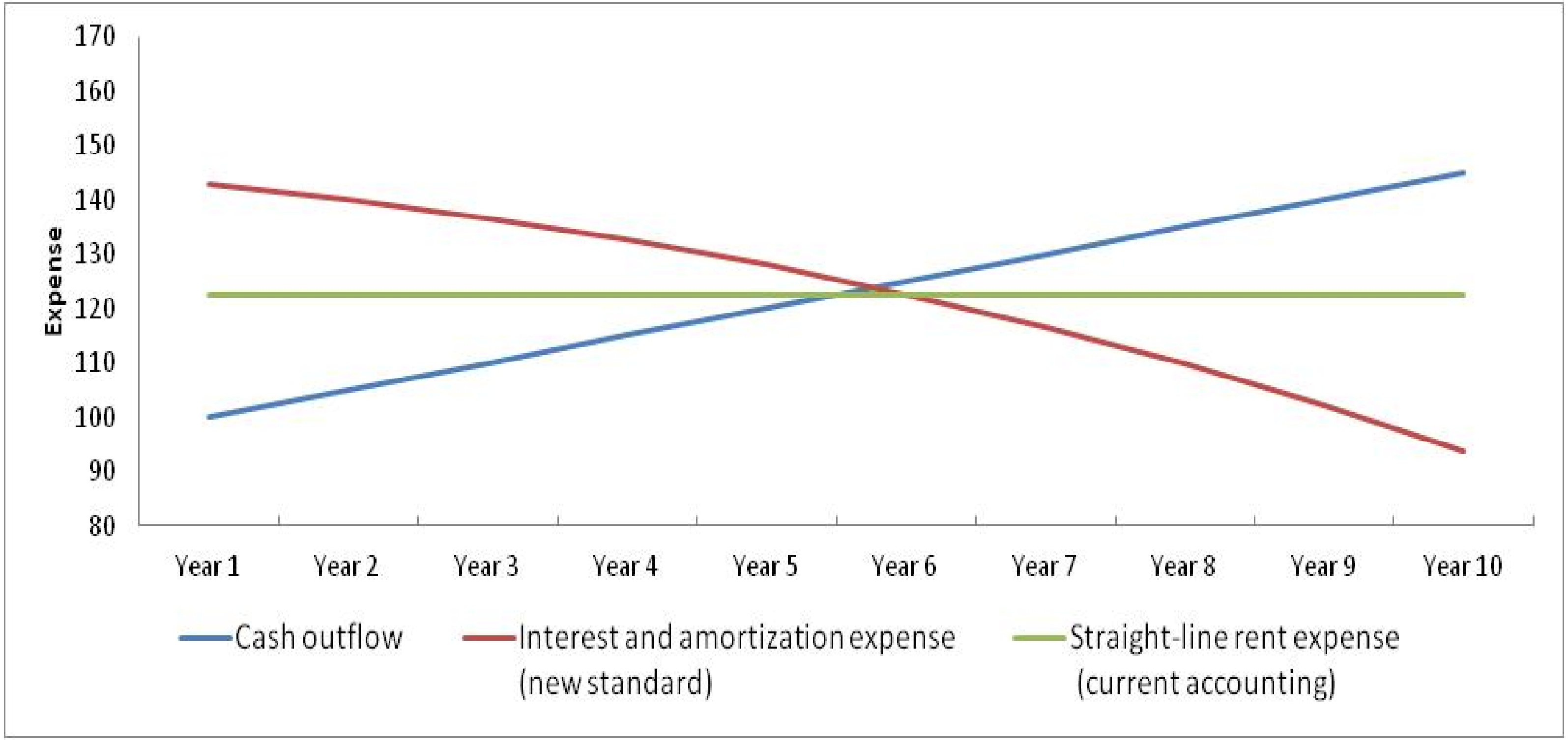
A lessee enters into a three-year lease and agrees to make the following annual payments at the end of each year: $10,000 in year 1, $15,000 in year 2, and $20,000 in year 3. The initial measurement of the right-of-use asset and liability to make lease payments is $38,000 at a discount rate of 8%.

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

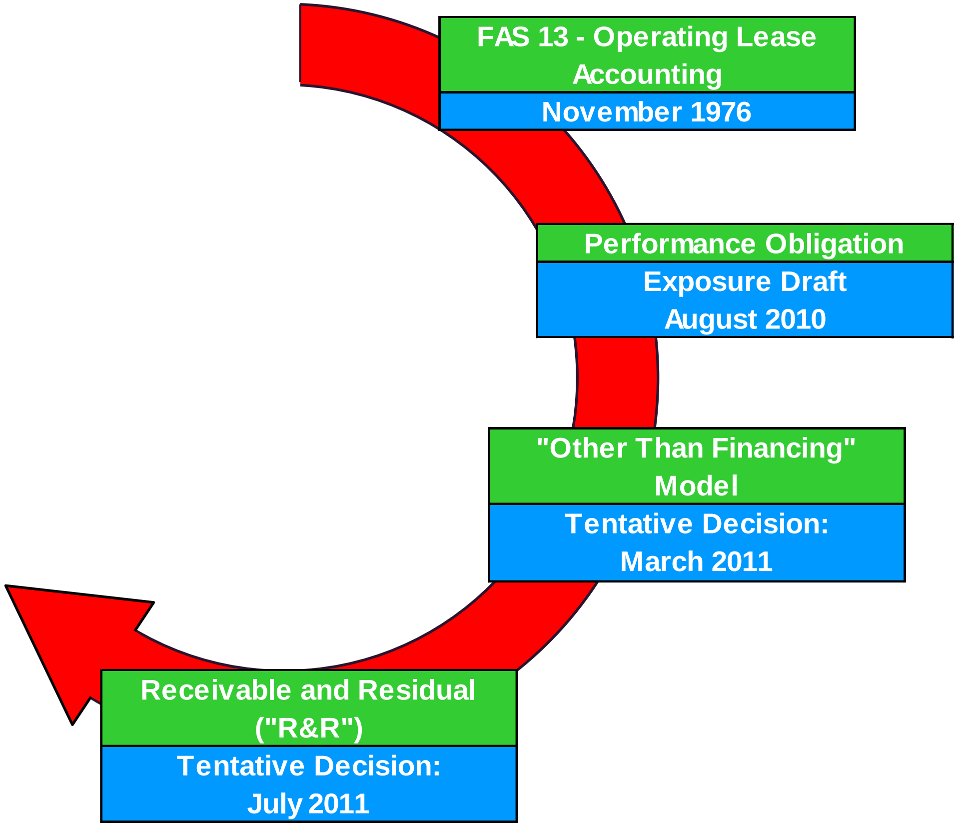
	Both Methods	Financing Approach				Straight-Line Expense Approach		
Year	Lease Liability	Interest Expense <X>	Amortization Expense <Y>	Total Lease Expense <X + Y>	Right-of-Use Asset	Lease Expense <Z>	Reduction in Right-of-Use Asset <Z – X>	Right-of-Use Asset
0	$ 38,000				$ 38,000			$ 38,000
1	31,038	$ 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

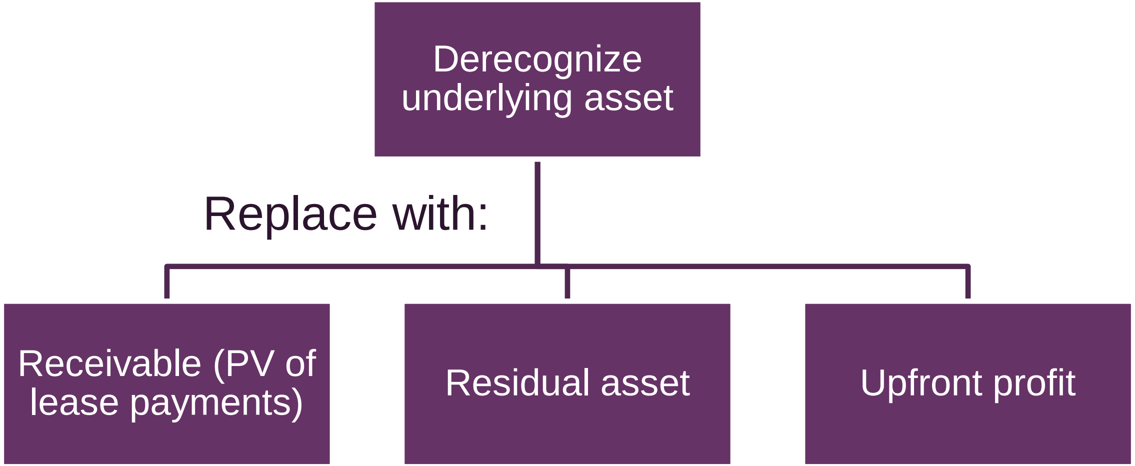


Lessor accounting…



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**

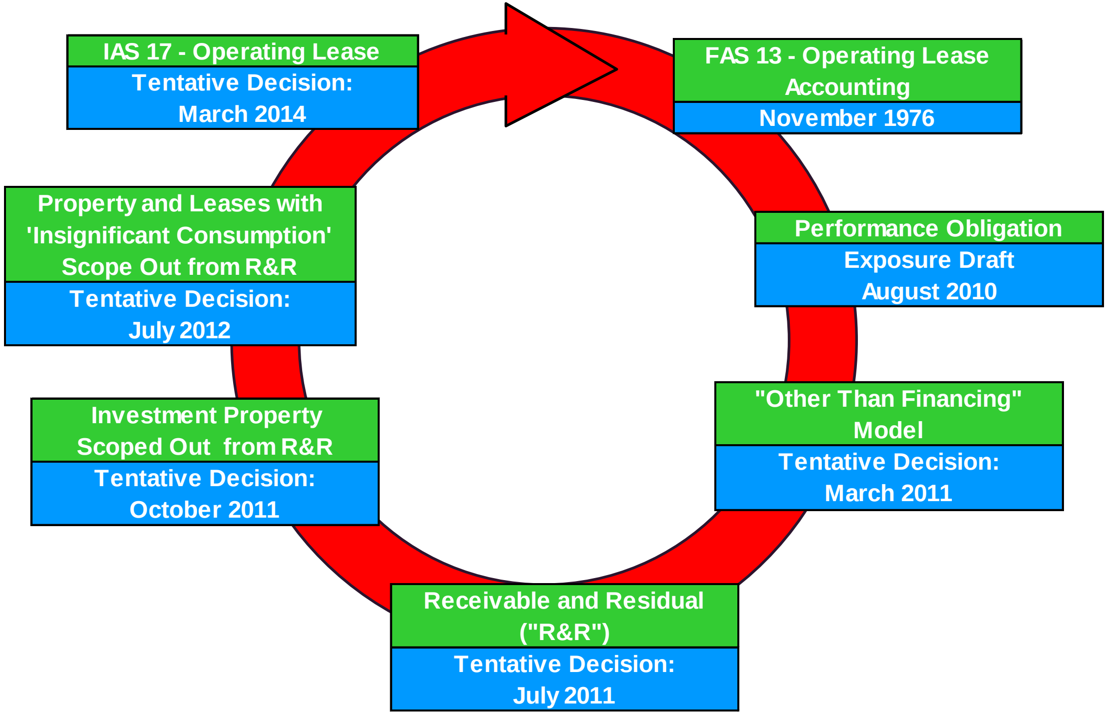
NAREIT spoke, the FASB listened

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

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

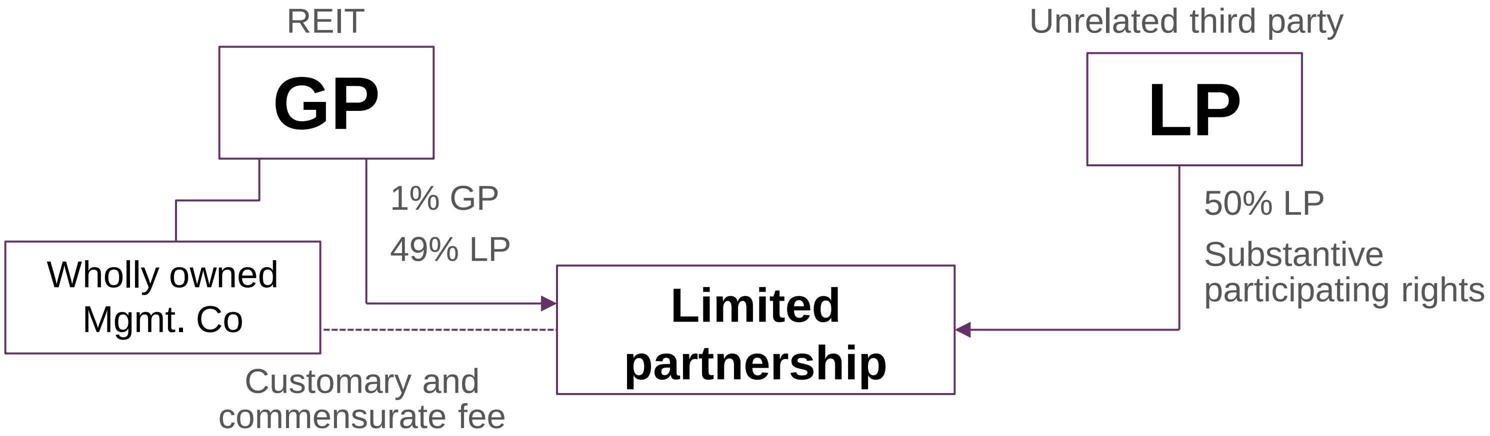
- Evaluation previously focused on whether general partner’s at-risk equity investment was substantive

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

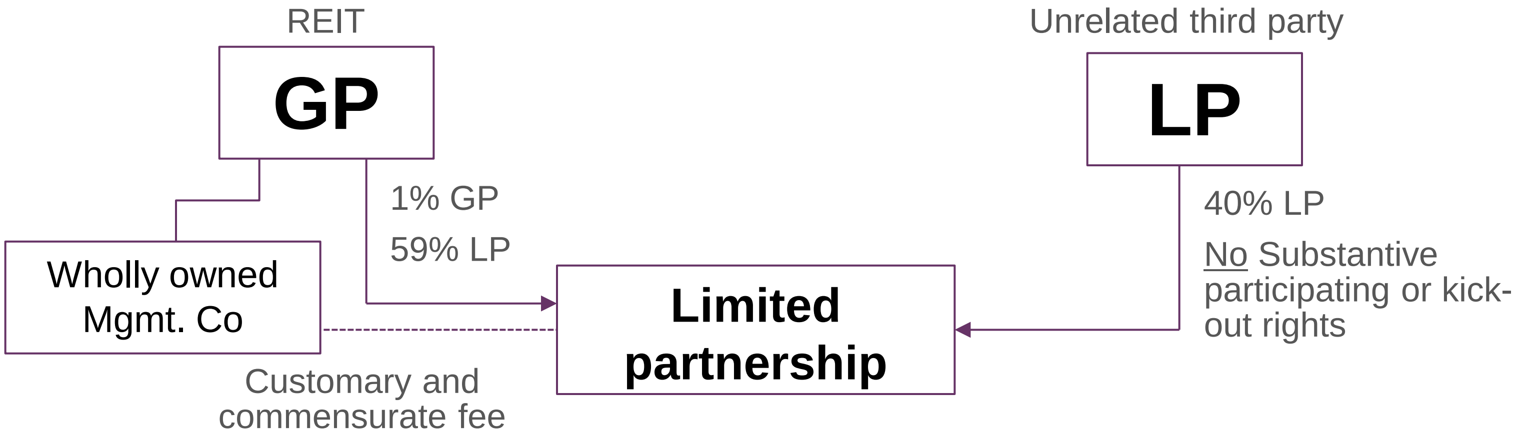


FAS 167: Limited partnership is not a VIE because an at-risk equity holder makes significant decisions. Applying the ASC 810-20 voting model, no party would consolidate

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?

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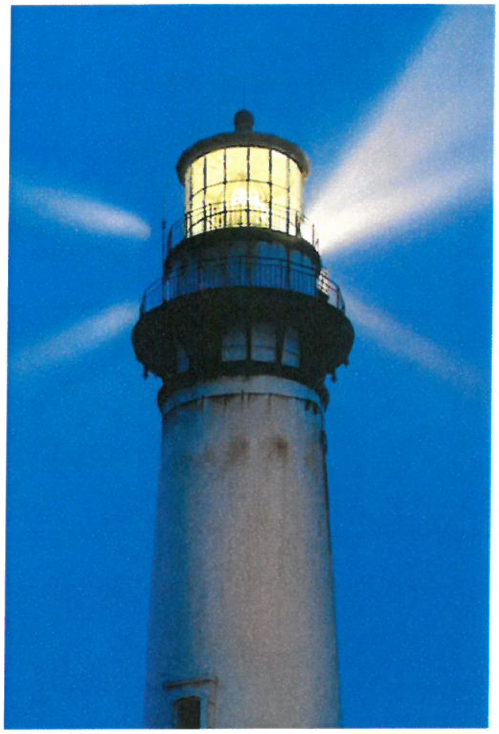
Defining Issues®

June 2015, No. 15-27



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FASB and IASB to Propose Amendments to Principal-Agent Guidance in Revenue Standard

At their June 2015 joint meeting, the FASB and IASB decided to propose amendments to their respective revenue recognition standards to clarify how the principal versus agent guidance should be applied for determining whether revenue should be presented gross (as a principal) or net (as an agent).[1]

Key Facts

- This will be the FASB's third exposure draft to improve the understandability and operability of the revenue standard since its issuance in May 2014, although this will be the first proposed amendment to the principal-agent guidance. In addition, the FASB issued an exposure draft proposing to defer the standard's effective date by one year.[2]
- The FASB's proposal will not amend principal-agent guidance in existing U.S. GAAP.[3]
- The IASB intends to issue a single exposure draft containing all of its proposed amendments to its standard.

Key Impact

- The Boards' decisions aim to minimize diversity in practice while maintaining substantial convergence between U.S. GAAP and IFRS.

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[1] FASB Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers, available at www.fasb.org; IFRS 15, Revenue from Contracts with Customers.

[2] FASB Proposed Accounting Standards Update, Deferral of the Effective Date, April 29, 2015, available at www.fasb.org.

[3] FASB ASC Subtopic 605-45, Revenue Recognition – Principal Agent Considerations, available at www.fasb.org.

Gross versus Net Revenue Reporting

Gross versus net revenue reporting has been a complex issue for years. Arrangements that involve multiple parties providing goods or services to customers require a reporting entity to exercise significant judgment in evaluating whether it is a principal (presenting revenue gross) or an agent (presenting revenue net) in the transaction. Current U.S. GAAP includes indicators to be evaluated in making this determination. Applying these indicators has often been challenging for preparers, particularly in an evolving economic environment that now includes virtual goods and services.

The revenue standard supersedes existing principal-agent guidance and requires an entity to determine if the nature of its performance obligation is to provide specified goods or services to the customer (the entity is a principal) or to arrange for another party to provide those goods or services (the entity is an agent). The standard specifies that an entity is a principal if it controls the goods or services before transferring them to the customer. The standard also provides indicators of when an entity is acting as an agent.

Principal versus Agent Considerations

Questions have arisen about how the control principle in the implementation guidance interacts with the agency indicators. Some question whether the control principle should be applied independently of the indicators (e.g., based on how control is evaluated elsewhere in the revenue standard) or whether the agency indicators are part of the control assessment. Some have suggested that the indicators are confusing because they do not directly answer the question of whether an entity controls goods or services before transfer. Also, some have questioned whether, and if so how, some indicators should be weighted more heavily than others, particularly when indicators provide contradictory evidence.

Determining whether an entity controls goods or services is particularly difficult in contracts for the transfer of a nonphysical item (e.g., a software developer sells its app through another party's website) or the provision of some services (e.g., an entity arranges for its advertising to be placed on another party's website through a virtual advertising exchange). In those situations it may not be clear how the control principle interacts with the agency indicators. It also may not be clear which party is responsible for fulfilling the contract, what constitutes inventory risk, how to identify an entity's promise, or how to identify the customer.

The Boards decided to retain the control principle as the basis for determining whether an entity is a principal or an agent. To facilitate this determination, the Boards decided to propose four amendments to the revenue standard.

Entities Must Identify the Nature of the Specified Good or Service Provided to the Customer. This could include a right to goods or services (e.g., an airline ticket) or a bundle of goods or services that are not distinct from each other. This amendment's objective is to more clearly link the unit of account in the principal-agent analysis with the guidance on identifying performance obligations.

Clarify How an Entity Can Control a Service. The standard would state that an entity that is a principal controls a right to a service to be performed by a third party, which gives the entity the ability to direct the third party on the entity's behalf. For example, an entity enters into a maintenance services contract with a customer and engages a third party to perform those services under the entity's direction.

Re-frame Indicators to Provide Evidence of When an Entity Controls a Specified Good or Service. These indicators would be provided instead of indicators of when the entity is an agent. Although the amendment would not provide guidance on how to weight the indicators, it would clarify that certain indicators may be more or less persuasive based on facts and circumstances. The indicators are not intended to be all-inclusive.

Revise Examples. Some examples in the revenue standard would be revised and others would be added, specifically those focused on linking the principal-agent conclusion to the notion of control and illustrating how the indicators should be used to support the evaluation of control.

The joint staff paper included an example in which a retailer does not obtain title to its inventory, except momentarily at the point of sale (referred to as flash title). The Boards discussed the example and agreed that the retailer controls the products before they are transferred to the end customer and is therefore the principal in the transaction. However, the Boards expressed reluctance to include the example in the proposed amendments as they believe contracts are often unique, and changes in facts and circumstances could result in a different conclusion.

IASB Actions on Principal versus Agent Considerations

The IASB reaffirmed its prior decision to add examples to IFRS 15 to clarify the application of the principal versus agent guidance.[4] The IASB also agreed with the FASB's clarifications to the principal versus agent guidance and will propose similar amendments to IFRS 15.

Estimating Gross Revenue

In some arrangements in which another party is involved in making an entity's goods or services available to a customer, the entity may be the principal but does not know the price paid by the end customer to the other party. For example, an app developer sells its products through a social media intermediary. The intermediary pays the app developer a fixed amount for each product sold. However, the intermediary does not report to the app developer the amounts charged to the end customers.

In current practice, some companies report the amount received from the other party as revenue. Other companies report the estimated amount charged to the end customer as revenue and the difference between the estimated amount and the amount received as a cost.

The FASB directed the staff to perform additional outreach about whether an entity applying the amended principal versus agent guidance could reach a conclusion that it was a principal in a transaction with an end customer when the entity uses an intermediary and does not know the price (or will not know the price) charged by the intermediary (i.e., the intermediary is not the entity's customer). Once it has these results, the FASB will decide whether additional amendments to the standard are needed to achieve consistency in practice.

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[4] IFRS 15, Revenue from Contracts with Customers.

IASB Actions on Estimating the Transaction Price

The IASB decided not to amend its standard to estimate the transaction price as a principal because the issue only affects a limited population of contracts. Feedback from constituents indicated that they were generally able to apply judgment and reach reasonable conclusions.

Next Steps

The FASB and IASB will issue separate exposure drafts on principal versus agent considerations with clarifications and additional examples. Prior to issuing its exposure draft, the FASB will discuss how to estimate gross revenue at a future Board meeting. The FASB and IASB expect to have joint redeliberations on their respective exposure drafts on principal-agent guidance.

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

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Earlier editions are available at: http://www.kpmg-institutes.com

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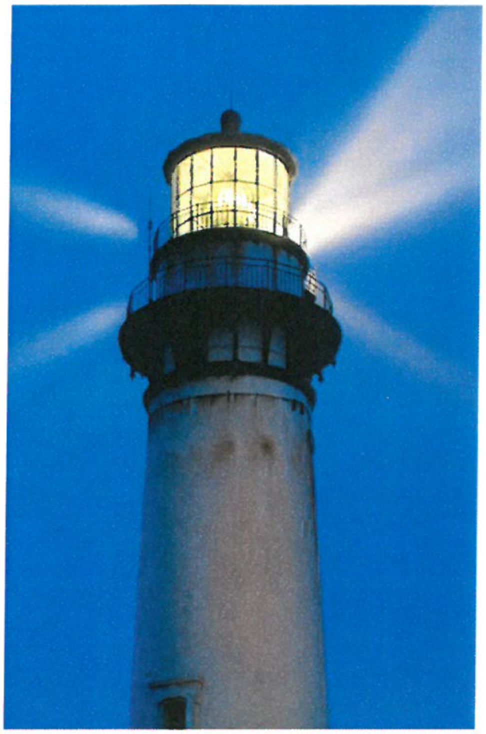
February 2016, No. 16-6



Contents

FASB Balloons Balance Sheet with New Lease Accounting Standard

The FASB's new lease accounting standard ushers in a new era in which lessees will recognize most leases on-balance sheet.[1] This will increase their reported assets and liabilities – in some cases very significantly. Lessor accounting remains substantially similar to current U.S. GAAP but with some important changes.

Well before the new standard becomes effective, lessees and lessors will need to assess how widespread its effects will be so they can plan for necessary business and process changes.

Effective Dates and Transition

	The entity is ...	
Question	**... a public business entity[2]**	**... any other type of entity**
When does Topic 842 take effect?	Annual and interim periods in fiscal years beginning after **12/15/2018**	• Annual periods beginning after **12/15/2019** • Interim periods in fiscal years beginning after **12/15/2020**
Can entities early adopt?	Yes, all entities can adopt Topic 842 immediately	
What is the transition method?	Modified retrospective, with elective reliefs, which requires application of the new guidance for all periods presented	

[1] FASB ASC Topic 842, Leases, issued February 25, 2016. Topic 842 replaces ASC Topic 840, Leases (current U.S. GAAP). Both are available at www.fasb.org.

[2] This includes (a) not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed, or quoted on an exchange or an over-the-counter market and (b) employee benefit plans that file or furnish financial statements with or to the U.S. Securities and Exchange Commission.

Modified Retrospective Transition

Lessees and lessors will apply the new guidance at the beginning of the earliest period presented in the financial statements in which they first apply the new standard. This may significantly change comparative period balance sheets from what was previously reported for many lessees.

The modified retrospective approach includes elective reliefs that all lessees and lessors may apply in transition. These include:

Must be elected as a package	• At the adoption date, the entity may elect not to reassess: – Whether expired or existing contracts contain leases under the new definition of a lease; – Lease classification for expired or existing leases; and – Whether previously capitalized initial direct costs would qualify for capitalization under the new standard
May be elected individually or with the other practical expedients	• The entity may use hindsight in determining the lease term and in assessing impairment of right-of-use (ROU) assets

An entity that elects to apply all of the practical expedients will, in effect, continue to account for leases that commence before the effective date in accordance with current U.S. GAAP unless the lease is modified (or remeasured) on or after the effective date, except that lessees are required to:

- Recognize a ROU asset and a lease liability for all operating leases at each reporting date based on the present value of the remaining minimum rental payments under current U.S. GAAP; and
- Apply the new requirements with respect to changes in estimates that affect lease accounting during the lease term (i.e., reassessments as discussed further below) beginning on the effective date.

The new standard also provides specific transition guidance for sale-leaseback transactions, build-to-suit leases, leveraged leases, and amounts previously recognized for leases in business combinations. This guidance will, for example, conform the determination of whether a lessee in a build-to-suit lease arrangement will recognize the entire underlying asset on its balance sheet to the requirements in the new standard.

Key Impacts to Lease Accounting

Lessees Will Recognize Most Leases on-Balance Sheet. All leases, including operating leases, will be recognized on-balance sheet via a *ROU asset* and *lease liability*, unless the lease is a short-term lease (i.e., one with an accounting lease term of *12 months or less*). This may require a substantial effort to identify all of the entity's leases and accumulate the lease data necessary to apply the new guidance. Lease classification will determine whether a lease is reported as a financing transaction in the income statement and statement of cash flows.

New Judgments Are Required to Identify a Lease. The definition of a lease is the new test for whether a transaction is on- or off-balance sheet. While the new definition is similar to current U.S. GAAP and will yield similar results in most cases, some arrangements that currently contain a lease no longer will. In addition, a new requirement to determine whether the customer has the right to direct the use of the identified asset will require significant new judgments.

Lessee Reassessments Will Require New Processes and Controls. Lessees will be required to reassess, and potentially change, aspects of their accounting for leases (e.g., assessments of the lease term, lessee purchase options, and lease classification) during the lease term, and remeasure lease assets and lease liabilities even if there is not a lease modification.

Accounting for Executory Costs. All (or a portion of) fixed payments by the lessee to cover lessor costs related to ownership of the underlying asset (e.g., property taxes or insurance – also referred to as executory costs) that do not represent payments for a good or service will be considered *lease payments* and reflected in the measurement of lease assets and lease liabilities by lessees (and in the lessor's net investment in the lease for sales-type and direct financing leases). Under current U.S. GAAP, payments for executory costs, including those to reimburse lessors for costs related to the underlying asset, are excluded from *minimum lease payments* and, therefore, from lease accounting.

Collectibility Considerations and Variable Payments Will Affect Lessors' Accounting in New Ways. While the new lessor accounting guidance is generally consistent with current U.S. GAAP, the new standard changes how lessors account for leases in which collectibility of the lease payments is uncertain. Lessors may now have to recognize some lease payments received as liabilities in those cases. The new standard also may affect leases for which there are significant variable payments because they no longer will be classified as operating leases solely due to the extent of variable payments. This may result in a negative implicit rate for the lease or loss recognition at lease commencement.

Fewer Lease Origination Costs Will Be Capitalizable. The new standard has a narrow definition of *initial direct costs* that will require lessors and lessees to recognize more lease origination costs as expenses when incurred. Only incremental costs incurred as a result of the lease being executed (e.g., commissions) meet the new definition and can be capitalized. Accordingly, costs incurred to negotiate and arrange a lease that are *not incurred only as a result of executing the lease* (e.g., legal fees and certain internal employee costs) – some of which are capitalized under current U.S. GAAP – will now be expensed when incurred. This could particularly affect lessors that incur significant costs in the lease origination process.

Expanded Quantitative and Qualitative Disclosures. The new standard requires lessees and lessors to disclose more qualitative and quantitative information about their leases than current U.S. GAAP does. Entities should consider whether they have appropriate systems, processes, and internal controls to capture completely and accurately the lease data necessary to provide those expanded disclosures.

Significant Changes to Sale-Leaseback Accounting Will Affect Seller-Lessees and Buyer-Lessors. The new standard essentially eliminates sale-leaseback accounting as an off-balance sheet financing proposition. This is because seller-lessees will recognize a ROU asset and lease liability in place of the underlying asset (and any asset financing repaid with the sale proceeds). In addition, under the new guidance:

- There likely will be fewer failed sales in sale-leaseback transactions involving real estate, but there may be more failed sales in equipment sale-leaseback transactions.
- Buyer-lessors will have to consider the same sale guidance in the new revenue recognition standard as seller-lessees to determine whether they have purchased the underlying asset, which may result in a failed purchase.[3] A buyer-lessor accounts for a failed purchase as a financing arrangement (i.e., a loan to the seller-lessee) rather than the acquisition of an asset and a lease.
- Seller-lessees will recognize the entire gain from the sale of the underlying asset (i.e., the difference between the selling price and the carrying amount of the underlying asset) at the time the sale is recognized rather than over the leaseback term.

Current Build-to-Suit Lease Guidance Replaced. The new guidance on determining when a lessee controls an underlying asset before lease commencement probably will result in fewer transactions where the lessee is considered the accounting owner of an asset during the construction period than current U.S. GAAP.[4] This means that fewer build-to-suit lease arrangements will become subject to the sale-leaseback accounting requirements. The changes to the sale-leaseback guidance also make it easier for lessees to remove real estate assets recognized during the construction period from their books. Finally, the transition provisions of the new standard will permit many entities to derecognize *build-to-suit* assets and liabilities that have remained on the balance sheet after the end of the construction period under current U.S. GAAP.

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[3] FASB ASC Topic 606, Revenue from Contracts with Customers, available at www.fasb.org.

[4] FASB ASC paragraphs 840-40-55-2 through 55-16.

Tell Me More

This section provides more information about some of the key differences between the new lease accounting standard and current U.S. GAAP.

A lessee will recognize a ROU asset and a lease liability on its balance sheet for most leases, which is a significant change from current U.S. GAAP.

Most Leases on-Balance Sheet for Lessees

Under the new standard, a lessee will recognize a (financial) lease liability and a (nonfinancial) ROU asset for all leases, including operating leases, with a term greater than 12 months on its balance sheet.[5] This effectively means that lessees will appear more asset-rich, but also more heavily leveraged. On-balance sheet recognition for most leases shifts the critical accounting determination from lease classification under current U.S. GAAP to whether a contract is, or contains, a lease under the new standard.

The current accounting model for lessees distinguishes between capital leases, which are recognized on-balance sheet, and operating leases, which are not. The lease classification distinction continues to exist in the new standard, but it now affects how lessees measure and present lease expense and cash flows – not whether the lease is on- or off-balance sheet.

Changes Introduced by Topic 842			
Lease Classification	**Balance Sheet**	**Income Statement**	**Statement of Cash Flows**
Finance Leases	✔ Similar to capital lease accounting under current U.S. GAAP		
Operating Leases	⚠ **Recognized on-balance sheet under Topic 842**	✔ Similar to operating lease accounting under current U.S. GAAP	

KPMG Observation

Recognizing ROU assets and lease liabilities for all leases other than short-term leases will enhance balance sheet transparency. Currently, many analysts adjust financial statements for off-balance sheet lease obligations. After the new requirements are applied, analysts will be able to see an entity's own assessment of its lease liabilities, calculated using a methodology that all entities reporting under U.S. GAAP must follow. However, because analysts do not all evaluate leases in the same way or for the same reasons, they may continue to make adjustments to lessee financial statements after the new standard becomes effective.

[5] Lessees may *elect*, by class of underlying asset, not to recognize short-term leases on the balance sheet and instead account for them in the same manner as current operating leases.

Measurement of the Lease Liability and the ROU Asset

Under the new standard, the lease liability at lease commencement and throughout the lease term (for both finance and operating leases) equals the present value (PV) of the unpaid *lease payments*, discounted at the *rate implicit in the lease* (if known) or the lessee's *incremental borrowing rate*. *Lease payments* exclude contingent payments other than in-substance fixed payments.

Lease liability = PV of *unpaid* lease payments

The ROU asset (for finance and operating leases) is initially measured as:

Lease liability + Initial direct costs + Prepaid lease payments − Lease incentives received

Subsequent measurement of the ROU asset (i.e., after lease commencement) depends on the classification of the lease. ROU assets, whether resulting from a finance lease or an operating lease, are subject to the long-lived asset impairment guidance.[6] After a ROU asset is impaired, it is measured in the manner depicted below for finance lease ROU assets, regardless of lease classification.

Finance Lease

ROU asset = Beginning balance − Accumulated amortization

The ROU asset is amortized generally on a straight-line basis over the lease term.

ROU assets that are impaired are measured in the same manner as finance lease ROU assets after the impairment, regardless of lease classification.

Operating Lease

The subsequent measurement of the ROU asset in an operating lease can be determined in either of two ways, which yield the same carrying amount.

- **Method 1 – Amortize the ROU Asset**

ROU asset = Beginning balance − Accumulated amortization

The amortization of the ROU asset each period equals the difference between the straight-line lease cost for the period (which is effectively the

[6] FASB ASC Topic 360, Property, Plant, and Equipment, available at www.fasb.org.

cost recognized for operating leases under current U.S. GAAP) and the periodic accretion of the lease liability using the effective interest method.

- **Method 2 – Derive the ROU Asset from the Lease Liability**

  The carrying amount of the ROU asset is derived from the carrying amount of the lease liability at the end of each reporting period as illustrated below.

  Lease liability + **Unamortized initial direct costs** +/(–) **Prepaid/ (accrued) lease payments** – **Unamortized balance of lease incentives received**

  Method 2 is what a lessee would use if it does not want to recognize ROU assets and lease liabilities for operating leases until it closes its books during the financial reporting process. Under this method, at each reporting date, the lessee creates a journal entry to (1) credit a lease liability for the present value of the remaining unpaid lease payments, (2) reverse other accrual-based operating lease accounting balances reflected in the balance sheet (i.e., prepaid or accrued rent, unamortized initial direct costs, and unamortized lease incentives), and (3) debit a ROU asset for the balancing amount.

Example – Subsequent Measurement of Operating ROU Asset

Assume a 5-year operating lease with annual payments (in arrears) of $100 that increase by $5 per year and a discount rate of 6%. Also assume that the lessee incurs $10 of initial direct costs. At lease commencement the lease liability equals $461 and the ROU asset equals $471 (the lease liability plus the initial direct costs). The lessee will recognize straight-line lease cost of $112 each year of the lease, which includes $2 in amortization of initial direct costs.

Method 1

Year 1 amortization of the ROU asset is $84, calculated as the Year 1 lease cost – Year 1 accretion of the lease liability ($112 – [$461 × 6%]). The end of Year 1 carrying amount of the ROU asset is therefore $387 ($471 – $84).

Year 2 amortization of the ROU asset is $89, calculated as the Year 2 lease cost – Year 2 accretion of the lease liability ($112 – [$389 × 6%]). The end of Year 2 carrying amount of the ROU asset is therefore $298 ($387 – $89).

Method 2

At the end of Year 1 the lessee has an accrued rent balance of $10 ($110 lease cost excluding amortization of initial direct costs – $100 lease payment) and unamortized initial direct costs of $8 ($10 – $2 in Year 1 amortization). The carrying amount of the lease liability at the end of Year 1 is $389 (present value of remaining unpaid lease payments discounted at 6%). Therefore, at the end of Year 1 the carrying amount of the ROU asset is $387 ($389 – $10 + $8).

Example – Subsequent Measurement of Operating ROU Asset
At the end of Year 2 the lessee has an accrued rent balance of $15 ($110 lease cost excluding amortization of initial direct costs – $105 lease payment + previous accrued rent balance of $10) and unamortized initial direct costs of $6 ($10 – $2 in Year 1 amortization – $2 in Year 2 amortization). The carrying amount of the lease liability at the end of Year 2 is $307 (present value of remaining unpaid lease payments discounted at 6%). Therefore, at the end of Year 2 the carrying amount of the ROU asset is $298 ($307 – $15 + $6).

KPMG Observations

Method 2 is the only method described in the new standard. In the standard's Basis for Conclusions, the FASB indicated that this method will permit many entities to perform the new accounting for operating leases without significant changes to systems or processes. However, we believe Method 2 generally will not be practicable to apply for entities other than those with few leases that are relatively straightforward. Method 2 is inherently a manual process that likely will be unwieldy when applied to a large portfolio of leases, especially in the context of the more complex circumstances that will arise under the new standard (e.g., modifications, remeasurements, impairments, and issues related to foreign exchange).

We believe Method 1 will more readily enable a lessee to implement systems, processes, and internal controls where lease liabilities and ROU assets are tracked separately in a manner more consistent with other assets and liabilities. It is more likely to be effective for addressing the more complex circumstances outlined above that are likely to arise for many lessees.

Additional judgments will be required in determining whether a contract contains a lease. Correctly identifying leases will have a greater effect on financial reporting than under current U.S. GAAP because this is the new on- / off-balance sheet test.

Identifying a Lease

A lease exists under the new standard when a contract conveys to the customer the right to control the use of identified property, plant, or equipment for a period of time in exchange for consideration. The definition of a lease embodies two conditions that are familiar under current U.S. GAAP: (1) there is an identified asset in the contract that is land or a depreciable asset (i.e., property, plant, and equipment), and (2) the customer has the right to control the use of the identified asset.

- Asset is explicitly or implicitly specified in the contract;
- Asset is physically distinct: applies to distinct portions but not generic capacity; and
- Supplier does not have a substantive substitution right.

- Customer has the right, throughout the *period of use*, to:
  - Obtain substantially all of the economic benefits from use of the asset; and
  - Direct the use of the asset.

While those two conditions appear similar to the requirements under current U.S. GAAP, important details have changed. Most notably, determining whether the customer has the right to control the use of an identified asset is now closely aligned with how control is defined and applied in the new revenue recognition standard. This is because there is now both a "benefits" element and a "power" element to the evaluation of control.

In most cases, a customer will have the right to direct the use of an identified asset if it can direct (and change) how and for what purpose the asset will be used throughout the period of use by controlling what, when, and/or how much output the asset produces. However, if the asset's use is predetermined before the beginning of the lease term (e.g., in the contract or by the asset's design), a customer is still deemed to direct the use of the asset if it (a) has operational control over the asset or (b) designed those aspects of the asset that predetermine how and for what purpose it will be used throughout the lease term.

KPMG Observations

In general, we believe that most arrangements that meet the definition of a lease under current U.S. GAAP will continue to meet the definition of a lease under the new standard. However, because of the new direct-the-use aspect of the definition, *some* contracts that were previously considered to be leases under current U.S. GAAP will not meet the new definition of a lease. This is most likely to be the case for arrangements that meet the current definition of a lease solely because the customer receives substantially all of the output or utility from the identified asset (e.g., some power purchase or outsourcing arrangements). Judgment will be required in applying the new definition, and companies will have to familiarize themselves with the changes from current U.S. GAAP, in particular the new guidance about directing the use of an identified asset.

Given the pervasive, and potentially material, effect that the lease reassessment guidance will have on a lessee's financial statements, lessees will need to implement new processes and controls to address the new risk points. This effort likely will need to involve cross-functional coordination to ensure timely identification of events requiring revisions to lease accounting.

Lease Accounting Requires Circumstance-Driven Reassessments by Lessees

The new standard requires a lessee to revise (or update) its lease accounting by remeasuring its lease liability in any of the following circumstances:

1. There is a change in the assessment of the lease term;
2. There is a change in the assessment of whether the lessee will exercise an option to purchase the underlying asset;
3. There is a change in the amount probable of being owed by the lessee to satisfy a residual value guarantee; or
4. A contingency is resolved that results in some or all of the variable lease payments that were to be paid over the remainder of the lease term becoming fixed. For example, if the payments for Years 2-10 of a retail store lease will be based on 10 percent of Year 1 retail store sales, at the end of Year 1, the lease payments for Years 2-10 become fixed payments.

A lessee reassesses the lease term (#1) or the likelihood that a purchase option will be exercised (#2) only when a significant event or a significant change in circumstances occurs that is within the lessee's control and directly affects whether the lessee is reasonably certain to exercise a renewal or a purchase option (i.e., a triggering event). The new standard identifies example triggering events, including a decision by the lessee to construct significant leasehold improvements that are expected to have substantial economic value at the end of the lease term or to enter into a sublease that effectively requires exercise of a renewal option.

The accounting steps a lessee must undertake depend on the circumstances.

	Circumstance			
Accounting Steps	**1**	**2**	**3**	**4**
Remeasure and reallocate the consideration in the contract to the remaining lease and non-lease components of the contract.	✔	✔	✔	✔
Remeasure the lease liability to reflect the revised lease payments, using a discount rate determined at the remeasurement date.[7]	✔	✔	✘	✘
Remeasure the lease liability to reflect the revised lease payments, using the original discount rate.[7]	✘	✘	✔	✔
Adjust the amount of the ROU asset by the amount of the remeasurement of the lease liability. However, once the ROU asset is reduced to zero, then the remaining amount of the lease liability remeasurement is recognized in the income statement.	✔	✔	✔	✔

[7] When the *lease payments* are remeasured, variable lease payments that depend on an index or a rate are remeasured using the index or rate as of the remeasurement date.

	Circumstance			
Accounting Steps	**1**	**2**	**3**	**4**
Reassess the lease classification at the remeasurement date based on the circumstances at that date (e.g., fair value and remaining economic life of the underlying asset at the remeasurement date).	✓	✓	✗	✗
If there is a change in lease classification, adjust the remaining lease cost recognition pattern and presentation in the income statement and statement of cash flows prospectively.	✓	✓	✗	✗

KPMG Observations

The reassessment and remeasurement guidance applicable to lessees is a significant change from current U.S. GAAP, which generally does not require revisions to lease accounting for lessees or lessors unless the terms and conditions of the contract are modified. Lessees will have to implement processes and controls to monitor for events or changes that require revisions to the accounting for a lease.

Some Executory Costs May Be Included in Lease Assets and Lease Liabilities

Payments to cover the lessor's costs of ownership, such as property taxes and insurance, are no longer excluded from lease accounting as they are under current U.S. GAAP.

The new standard only governs the accounting for leases. If there are lease and non-lease (e.g., service) components of a contract, lessors must apply the new standard to the lease component(s) and other GAAP to the non-lease component(s). Lessees have the option to either separately account for lease and non-lease components or account for any non-lease components as part of the lease component to which they relate. An entity separates lease and non-lease components of a contract and allocates the contract consideration to those components generally on a relative stand-alone price basis, which is broadly consistent with current U.S. GAAP. However, the guidance in the new standard may change how an entity identifies, separates, and allocates contract consideration to the components of a contract.

Specifically, the new standard states that lessee payments for lessor ownership costs of an underlying asset (e.g., property taxes or insurance) do not transfer a good or service to the lessee and, therefore, are not components of the contract. Therefore, none of the consideration in the contract is allocated to those items. Instead, payments for those items are allocated to the lease and non-lease components on the same basis as the remainder of the consideration in the contract (i.e., generally on a relative stand-alone price basis). If there are no non-lease components, fixed payments for those costs will be accounted for entirely as *lease payments*. This treatment represents a change from current U.S. GAAP, under which all executory costs are excluded from minimum lease payments.

Current U.S. GAAP	Topic 842
All executory costs excluded from minimum lease payments	Executory costs that do not represent payments for a good or service are allocated to the lease and non-lease components in the same manner as all other payments in the contract

KPMG Observations

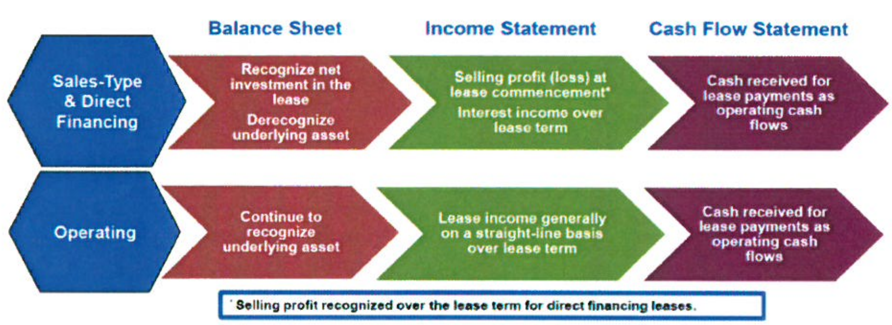
Lessees making fixed payments that cover the lessor's ownership costs for items like property taxes or insurance will recognize larger lease assets and lease liabilities than they would have if the new standard had retained the previous guidance that excluded all executory costs from lease payments. Maintenance services (e.g., common area maintenance) generally transfer a good or service to the lessee other than the right to use the underlying asset and are, therefore, a non-lease component of the contract. As a result, consideration is allocated to those services and that consideration generally is excluded from lease payments by lessees that elect to separately account for lease and non-lease components, and by lessors.

Because variable payments do not meet the new standard's definition of *lease payments*, lessees may account differently for economically similar leases based solely on how their payments are structured. All (or a portion of) payments that are structured as a direct pass-through of the lessor's actual costs are likely to meet the definition of variable lease payments, which a lessee will exclude from the measurement of its ROU asset and lease liability (and a lessor from its net investment in the lease), but be required to disclose. Conversely, all (or a portion of) fixed payments designed to cover lessor ownership costs will meet the definition of lease payments and be included in the measurement of the lessee's ROU asset and lease liability (and the lessor's net investment in the lease for sales-type and direct financing leases).

Changes to Lessor Accounting

Although Topic 842 does not substantially change lessor accounting, there are some important changes lessors should take note of.

The new standard does not substantially change lessor accounting from current U.S. GAAP as illustrated below.



In addition, most of the key definitions and concepts underlying the lessor accounting model are generally consistent with current U.S. GAAP (e.g., what is included in lease assets, the discount rate, and the lease classification test). However, there are some important changes that lessors should be aware of.

Collectibility

Under current U.S. GAAP, if collectibility of the *minimum lease payments* is not *reasonably predictable*, a lease is classified as an operating lease (i.e., it cannot be classified as a sales-type, direct financing, or leveraged lease). Topic 842 eliminates this reasonably predictable criterion and introduces new requirements with respect to collectibility.

- Uncertainty about the collectibility of the lease payments no longer will preclude a lease from being classified as a sales-type lease. However, if collectibility of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, is not probable in a sales-type lease, the lessor will (a) continue to recognize the underlying asset and (b) recognize lease payments received as a deposit liability generally until the earliest date that:
  - Collectibility becomes probable;
  - The contract is terminated and the lease payments received are nonrefundable; or
  - The lessor has repossessed the underlying asset, has no further obligations to the lessee under the contract, and the lease payments received are nonrefundable.
- For leases that are not sales-type leases, if collectibility of the lease payments and any amount necessary to satisfy a residual value guarantee (provided by the lessee or a third party) is not probable, the lease must be classified as an operating lease. Cumulative lease income is then limited to the amount of the lease payments (including variable lease payments) that have been paid unless the assessment of collectibility changes during the lease term.

Significant Variable Lease Payments

Current U.S. GAAP contains conditions under which lessors often classify leases with predominantly variable payments as operating leases even if the lease meets one of the four primary criteria to be classified as a sales-type or direct financing lease (e.g., the lease term is more than 75 percent of the asset's estimated economic life).[8] Operating lease classification for these leases eliminates the potential for up-front loss recognition solely because the present value of the minimum (i.e., non-variable) lease payments and unguaranteed residual value is less than the asset's carrying amount at lease commencement. However, those conditions are eliminated by the new standard. As a result, these leases are likely to be classified as sales-type or direct financing leases under the new standard, creating the potential for loss recognition at lease commencement.

[8] The primary classification criteria are in FASB ASC paragraph 840-10-25-1 and the other conditions are in ASC paragraph 840-10-25-42.

KPMG Observations

For leases with significant variable lease payments (e.g., in some renewable energy arrangements), the undiscounted sum of (a) the lease payments and (b) the estimated residual value of the underlying asset at the end of the lease term may be less than the underlying asset's fair value and/or carrying amount at lease commencement. If so, sales-type lease classification for these leases will require loss recognition at lease commencement when the discount rate used in measuring the lessor's net investment in the lease is positive even if the lessor expects the lease to ultimately be profitable. This does not seem to best reflect the economics of these leases.

The new standard requires the lessor to use the *rate implicit in the lease* as its discount rate to measure its net investment. That rate is defined in a way that generally requires the present value of (a) the lease payments and (b) the estimated residual value of the underlying asset at the end of the lease term to be no less than the underlying asset's fair value at lease commencement. For leases with significant variable lease payments, following that definition could mean that the lessor would be required to use a negative discount rate. It also could mean that no loss would be recognized at lease commencement unless the fair value of the underlying asset was less than its carrying amount.

It is not clear whether the FASB considered the possibility (or expected) that discount rates might be negative under the new standard's requirements. In addition, it is not clear to what extent the fact that the Board's new revenue recognition standard may require up-front loss recognition in arrangements with significant variable (or contingent) consideration even if the seller expects the arrangement to ultimately be profitable factored into its consideration of these leases. We expect the accounting for these transactions to generate further debate given the interplay between sales-type lease accounting and the new revenue recognition standard, and the current ambiguity around the Board's intent about lessor discount rates in these leases.

A Narrower Definition of Initial Direct Costs

The new definition of *initial direct costs* includes only those "incremental costs of a lease that would not have been incurred if the lease had not been obtained" (e.g., commissions or payments made to existing tenants to obtain the lease), which is a more narrow definition than in current U.S. GAAP. Accordingly, costs that an entity is permitted to capitalize as initial direct costs under current U.S. GAAP, such as external legal fees incurred to negotiate a lease or draft lease documents or allocations of internal employee costs for time spent directly related to negotiating or arranging a lease, will now be expensed when incurred.

KPMG Observations

While this issue is expected to affect lessors more than lessees, the narrowed definition of initial direct costs also may affect lessees that previously capitalized or deferred costs that do not meet the new, narrower definition. For some lessors the new definition may result in recognizing more expenses at the start of a lease and higher margins over the lease term.

Leveraged Lease Accounting Eliminated Prospectively

The new standard eliminates leveraged lease accounting for all leases that commence on or after the effective date of the new guidance. A lessor with a leveraged lease that commences before the effective date of the new standard will continue to apply leveraged lease accounting to that lease unless it is modified on or after the effective date. A lessee's exercise of an option to renew or extend a leveraged lease when exercise previously was not considered reasonably assured is considered a lease modification for this purpose.

Expanded Quantitative and Qualitative Disclosures

Increased disclosure requirements may necessitate additional systems capabilities, processes, and controls for lessees and lessors.

The new standard's disclosure objective is to provide financial statement users sufficient information to assess the amount, timing, and uncertainty of cash flows arising from leases. To achieve that objective, lessees and lessors will disclose qualitative and quantitative information about lease transactions. This generally will result in increased information being disclosed compared to current U.S. GAAP. Accordingly, entities will need to evaluate whether they have appropriate systems, processes, and internal controls to capture complete and accurate lease data necessary to prepare the financial statement notes.

<table>
<tr><th>Lessees</th><th>Lessors</th></tr>
<tr><td colspan="2">Example Qualitative Disclosures
• Information about leases
– Nature of variable payment arrangements
– Termination, renewal, and purchase options
• Significant accounting judgments and estimates</td></tr>
<tr><td>• Leases that have not yet commenced, but that create significant rights and obligations for the lessee, including involvement in construction or design of the underlying asset</td><td>• Information about how the lessor manages residual asset risk, including information about residual value guarantees and other means of limiting that risk</td></tr>
<tr><td colspan="2">Example Quantitative Disclosures</td></tr>
<tr><td>• Amortization of ROU assets and interest on lease liabilities (including amounts capitalized) for finance leases
• Operating lease cost
• Variable lease cost
• Short-term lease cost</td><td>• Table of lease income:
– Selling profit (or loss) recognized at lease commencement for sales-type leases and interest income for sales-type and direct financing leases
– Operating lease income
– Variable lease income</td></tr>
</table>

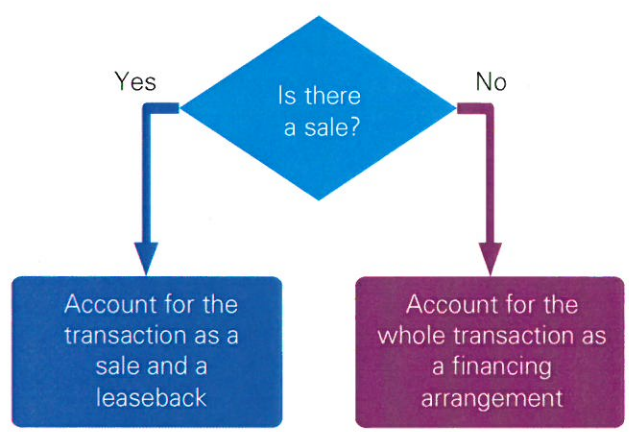
Lessees	Lessors
• Weighted-average remaining lease term, separately for finance and operating leases • Weighted-average discount rate as of the balance sheet date, separately for finance and operating leases • Maturity analysis of lease liabilities, reconciling undiscounted cash flows to the recognized lease liabilities, separately for finance leases and operating leases	• Maturity analysis of lease receivables, reconciling the undiscounted cash flows to the recognized lease receivables (for sales-type and direct financing leases), and of future lease payments (for operating leases) • For operating leases, general property, plant, and equipment disclosures by significant class of underlying asset separately from those disclosures for the lessor's other owned assets

Although Topic 842 eliminates sale-leaseback transactions as an off-balance-sheet financing proposition, sale-leaseback transactions still may attract interest because a seller-lessee generally will be able to recognize any gain on the sale in full at the sale date and the balance sheet effect of the leaseback may be less significant than that of the asset and related financing.

Sale-Leaseback Accounting Substantially Changed

Topic 842 essentially eliminates sale-leaseback accounting as an off-balance sheet financing proposition by requiring the seller-lessee to account for the leaseback in the same manner as other leases – i.e., on-balance sheet for most leases. However, some of the off-balance sheet benefits of sale-leaseback accounting are preserved as, in many cases, the amount of the ROU asset and the lease liability recognized may be substantially less than the previous carrying amounts of the underlying asset and any related financing.

If the transaction qualifies for sale accounting (i.e., the sale leg of the transaction meets the contract identification and transfer of control requirements for a sale in the new revenue recognition standard), a seller-lessee's balance sheet will reflect an asset that represents the seller-lessee's right to use the underlying asset and a liability to make the leaseback payments. However, if the sale-leaseback transaction does not qualify for sale accounting, the seller-lessee, *and* the buyer-lessor, will account for the whole arrangement as a financing transaction.



KPMG Observation

In a significant change from current U.S. GAAP, the buyer-lessor is required to evaluate whether a sale of the underlying asset has occurred based on the sale guidance in the new revenue recognition standard and, if a sale has not occurred, to account for the transaction as a financing arrangement. Under current U.S. GAAP, a failed sale for the seller-lessee is not accounted for as a failed purchase by the buyer-lessor. This may complicate the accounting by buyer-lessors, particularly for sale-leaseback transactions with significant variable payments that do not qualify for sale/purchase accounting.

Recognition of Gains on Sale No Longer Will Depend on the Rights Retained by the Seller-Lessee

Under current U.S. GAAP, the timing of gain recognition on the sale in a sale-leaseback transaction depends on the rights retained by the seller-lessee. In contrast, when a sale-leaseback transaction qualifies for sale accounting under the new standard, the seller-lessee is required to recognize the full amount of the gain (which will be adjusted for off-market terms, if any) when the buyer-lessor obtains control of the underlying asset. This is consistent with the guidance that will apply to the sale of any nonfinancial asset under either the new revenue recognition standard (if the sale is to a customer) or the other income accounting guidance (if the sale is to a non-customer).[9]

Different Sale-Leaseback Accounting Provisions for Real Estate and Assets Other Than Real Estate Eliminated

The new standard eliminates the different accounting for sale-leaseback transactions involving real estate versus other assets that exists in current U.S. GAAP. Under the new standard, the same guidance applies to all sale-leaseback transactions regardless of the type of underlying asset.

Sale-Leaseback Accounting Easier to Achieve for Real Estate Than under Current U.S. GAAP; More Difficult for Other Assets

The new standard stipulates that a sale is recognized in a sale-leaseback transaction when the transaction meets the contract identification and transfer of control requirements for the sale of goods in the new revenue recognition standard. It also includes additional guidance for recognizing a sale in a sale-leaseback transaction:

- The leaseback by itself does not preclude a sale-leaseback transaction from meeting the sale requirements in the new revenue recognition standard;
- A sale (purchase) is not recognized if the leaseback would be classified as a finance lease by the seller-lessee (sales-type lease by the buyer-lessor); and
- An option for the seller-lessee to repurchase the underlying asset results in a failed sale unless (a) the option strike price is the fair value of the asset at the option exercise date ***and*** (b) alternative assets that are substantially the same as the underlying asset are readily available in the marketplace.

[9] FASB Topic 610, Other Income, available at www.fasb.org.

KPMG Observations

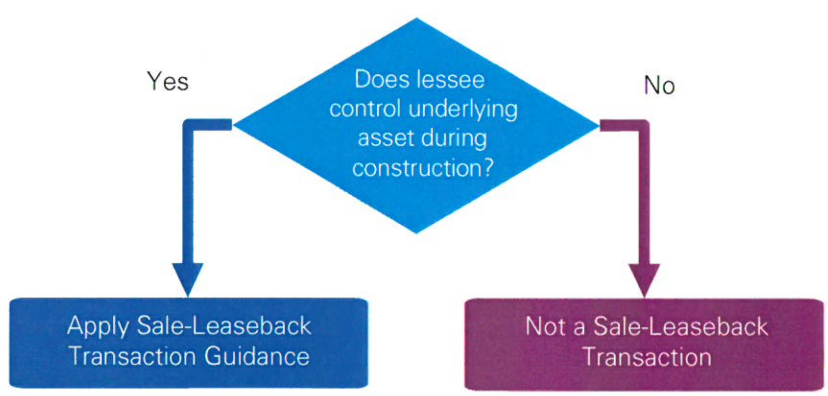
In the United States, equipment sale-leaseback transactions often include an option for the seller-lessee to repurchase the equipment. This does not result in a failed sale under current U.S. GAAP unless the option is a bargain repurchase option. Because most repurchase options will preclude a sale, the new standard will make it more difficult for many equipment sale-leaseback transactions to qualify for sale-leaseback accounting than under current U.S. GAAP.

Conversely, current U.S. GAAP requires failed sale accounting for real estate sale-leaseback transactions if the seller-lessee has any continuing involvement (including a repurchase option at any strike price) with the real estate other than a normal leaseback. As a result, failed sales are common in real estate sale-leaseback transactions. Because the new standard supersedes the continuing involvement provisions in current U.S. GAAP, and the sale requirements in the new revenue recognition standard are comparatively less difficult to meet, it generally will be easier for real estate sale-leaseback transactions to qualify for sale-leaseback accounting under the new standard than under current U.S. GAAP. However, a seller-lessee repurchase option generally will still preclude sale-leaseback accounting for a real estate sale-leaseback transaction, even if the strike price of the option is the fair value of the real estate on the exercise date. This is because two real estate assets typically will not be considered substantially the same.

Current Build-to-Suit Lease Accounting Guidance Replaced

Current U.S. GAAP addresses a lessee's involvement with the construction of an asset that the lessee will lease when construction is complete (i.e., build-to-suit lease accounting). Under that guidance, the transaction is subject to the sale-leaseback guidance if the lessee is deemed to be the accounting owner of the asset during the construction period because it has substantially all of the construction period risks (or meets other specified criteria).

The new standard supersedes the current build-to-suit lease accounting guidance and stipulates that a lessee is the accounting owner of an asset under construction when it *controls* that asset before the lease commencement date. The new standard includes implementation guidance to assist entities in determining whether the lessee controls an underlying asset that is under construction.



The new standard further specifies that payments made by a lessee for the right to use the underlying asset are not costs related to the construction or design of the underlying asset but are lease payments regardless of when the payments are made (e.g., before lease commencement) or how the payments are made (e.g., contribution of construction materials). When a lessee incurs costs related to the construction or design of an underlying asset for which it is not considered the accounting owner during the construction period, it will account for them as lease payments unless they relate to goods or services provided to the lessee (in which case it will account for them under other U.S. GAAP).[10]

KPMG Observations

The new guidance about when a lessee controls an asset under construction that it will lease is similar to the guidance in the new revenue recognition standard about when a customer controls an asset under construction (or that is being modified) that it will purchase.

We believe the new guidance will result in fewer instances where the lessee is deemed to be the accounting owner of an asset that is under construction, but those instances will still occur. However, importantly, when a lessee is deemed to be the accounting owner of an asset under construction, the changes to the sale-leaseback guidance in the new standard may make it easier for the lessee to derecognize the underlying asset at the end of the construction period.

Summary of Similarities and Differences between U.S. GAAP and IFRS

On January 13, 2016, the IASB issued IFRS 16, *Leases*, which requires lessees to recognize ROU assets and lease liabilities on-balance sheet for leases that are not short-term or of assets with a low value when new (e.g., $5,000 or less). IFRS 16 introduces a single, on-balance sheet lessee accounting model that is similar to the current accounting under IFRS for finance leases (and U.S. GAAP for capital leases). Lessor accounting will remain similar to current practice, (i.e., lessors will continue to classify leases as finance and operating leases).

IFRS 16 is effective for companies that apply IFRS for annual periods beginning on or after January 1, 2019. Earlier application is permitted for entities that apply IFRS 15, *Revenue from Contracts with Customers*, at or before the date of initial application of IFRS 16.

Although some key aspects of Topic 842 and IFRS 16 are converged (e.g., the definition of a lease and the recognition of most leases on-balance sheet), many are not, including the following:

- Lessee accounting model, including reassessment requirements for variable lease payments that depend on an index or rate;
- Lessor profit recognition for some leases;

[10] For example, FASB ASC Topic 330, Inventory, and Topic 360, Property, Plant and Equipment, available at www.fasb.org.

- Recognition and measurement exemption for leases of low-value assets under IFRS 16;
- Classification of subleases by the sublessor;
- Accounting for leases between related parties;
- Gain recognition on sale-leaseback transactions; and
- Transition requirements and alternatives.

Our summary table provides additional information about the similarities and differences between Topic 842 and IFRS 16.

Staying Informed

KPMG will host a CFO Financial Forum Webcast on March 7, 2016, to provide an overview of the new standard. This spring KPMG also will:

- Release an Issues In-Depth that provides a more comprehensive analysis of the new lease accounting standard.
- Host a series of CFO Financial Forum Webcasts to discuss specific aspects of the new standard in more detail.

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

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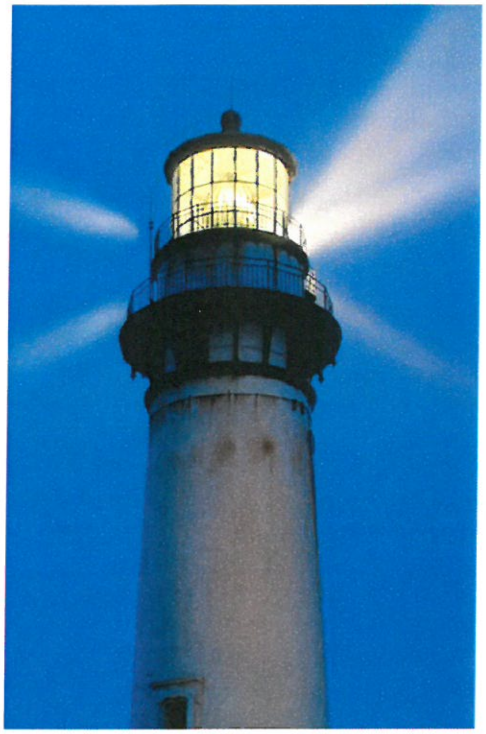
Earlier editions are available at: http://www.kpmg-institutes.com

Defining Issues®

October 2015, No. 15-47



Contents

FASB Completes Technical Redeliberations on Leases

The FASB met on October 7 to discuss comments received and related follow-up issues on the external review of its proposed leases standard. The Board will meet in early November to discuss effective date and cost-benefit considerations. The Board plans to issue a final leases standard by the end of 2015.

Key Facts

- Approximately 600 comments were received from external reviewers, though the FASB staff noted that many comments overlapped.
- The Board made decisions on three sweep issues to complete its technical decisions on the project.[1]
  - The lease modification guidance will be more closely aligned with the lease reassessment guidance.
  - Initial direct costs in sales-type leases will be deferred and recognized over the lease term if there is no selling profit (loss).
  - Lessors will present the net investment in sales-type and direct financing leases separate from other assets in the statement of financial position and will disclose the components of the net investment.
- The amount of expense recognized by lessees for operating leases will be measured like finance leases following an impairment of the lease.
- Private companies will not have additional reliefs other than the election to use a risk-free discount rate in measuring lease liabilities.

Key Impacts

- The standard setting on the leases project is almost over. Entities should begin planning their implementation efforts if they haven't done so already.
- Lease accounting for modifications that change the lease term will be consistent with the guidance on lease reassessments, which will reduce potential structuring opportunities.
- Lessor lease accounting will remain substantially consistent with current U.S. GAAP.[2]

[1] A sweep issue is a topic the FASB staff identifies for consideration or reconsideration by the Board.

[2] ASC Topic 840, Leases, available at www.fasb.org.

Summary of External Review Comments

The guidance developed by the FASB staff to address impairment of operating leases suggests the staff likely had significant discretion in deciding how to respond to external review comments.

In July 2015, the FASB distributed the leases external review draft to a select group of stakeholders with a deadline for comments of mid-August, 2015. The FASB staff received approximately 600 comments on the external review draft. At the October 7 FASB meeting, the FASB staff indicated that many of the comments were duplicative. In their view only three required further discussion by the Board, which the staff identified as sweep issues (see below). The staff noted that where comments expressed disagreement with Board decisions the staff generally took no action. For other comments, the staff indicated that revisions to the language in the external review draft would be made to clarify the guidance where necessary.

Lessee Accounting after Impairment of an Operating Lease. One issue that the staff indicated did not require further decision-making by the Board—although the staff plans to amend the draft standard—related to the accounting by lessees after impairment of an operating lease.[3] The staff noted that the guidance in the external review draft would have required the expense for an operating lease after an impairment charge to be determined in a way that would not result in balanced accounting entries. Consequently, the staff determined that the expense for operating leases following an impairment charge should be determined in the same way as it would be for finance leases.[4] Specifically, after an impairment of an operating lease right-of-use asset, the remaining balance of the right-of-use asset would be amortized generally on a straight-line basis over the remaining lease term and added to the periodic accretion of the lease liability to determine total lease expense each period. This is the same methodology that would be used for finance leases that are not impaired and would result in an uneven pattern of total expense that is front-loaded following the date of an operating lease impairment.

KPMG Observations

The FASB staff decided that the pattern of lease expense for an operating lease following an impairment of the lease should be consistent with the pattern of expense for an operating lease for which an onerous contract liability is recognized in accordance with ASC Topic 420, *Exit or Disposal Cost Obligations*. That guidance results in a pattern of expense for an operating lease that is essentially the same as the pattern of expense for a capital lease under current U.S. GAAP. Although this decision appears different than the Board's previous decision that the pattern of expense for an operating lease should generally be straight-line, even following an impairment, it seems consistent with the Board's more recent decision to make minimal changes to the way in which periodic expense would be measured for operating leases under the new guidance.

[3] Operating leases were referred to as Type B leases in the FASB's Proposed Accounting Standards Update (Revised), Leases, May 16, 2013 (the 2013 Exposure Draft), available at www.fasb.org.

[4] Finance leases were referred to as Type A leases in the 2013 Exposure Draft.

Sweep Issues Discussed

Lease Modifications That Extend the Lease Term

The Board discussed issues stemming from the proposed lease modification guidance that considered the right to use an underlying asset for an additional period of time as an additional right of use, separate from the original right to use the underlying asset. The Board also discussed peripheral issues related to the lessor lease modification guidance and lessee reassessment guidance.

Whether the Use of an Underlying Asset for an Additional Period of Time Is a Separate Right of Use. Under the proposed guidance, a lease modification granting a lessee the right to use the same underlying asset for an additional period of time would result in the lessee recognizing the additional lease liability and related right-of-use asset only when the additional period begins. That right of use would be considered separate from the original right of use whether or not the price for the additional period of use is commensurate with its stand-alone price. For example, assume a lessee originally entered into an agreement with a lessor to lease equipment for five years with no renewal options. At the end of Year 2, the lessee and lessor agree to modify the lease to extend its term for an additional five years from the original lease term expiration. Under the Board's previous decisions, the lease liability and related right-of-use asset for the extension period would not be recognized until the beginning of Year 6.

Conversely, the proposed guidance on lease reassessments would require lessees to revise the measurement of the right-of-use asset and lease liability when the lessee takes an action that changes the assessment of whether the exercise of a renewal option is reasonably certain to be exercised. Assume the example above was changed so that the lease included a five-year renewal option that was not included in the lease term for accounting purposes. If the lessee took an action at the end of Year 2 of the lease that made it reasonably certain that the lessee would exercise that renewal option, then the lessee's right-of-use asset and lease liability would be remeasured at the end of Year 2 to include the non-variable lease payments during the renewal period.

In addition, the Board previously decided that when a lease is modified and the additional right of use (in this case the right to use the underlying asset for an additional period of time) is commensurate with its stand-alone price, an entity would not reassess lease classification. Continuing with our original example, assume the equipment's remaining economic life is seven years at the modification date and rent during the 5-year extension period is commensurate with its stand-alone price. Because the additional period of use would be considered a separate lease, an entity would not reassess lease classification even though the lessee now benefits from the equipment's use for a major part of its remaining economic life. This indicates that the lease has become a finance lease rather than an operating lease.

To address these issues, the Board decided that the lease term is an *attribute* of the lease. Therefore, the Board concluded a lease modification that merely extends the term of the underlying asset's use would be recognized when the modification is executed.

Lessor's Lease Modification Guidance. As a result of considering the lease term an attribute of the lease, the Board discussed some of the potential asymmetries that may arise between the proposed lessor and lessee lease accounting guidance as well as the revenue guidance in ASC Topic 606.[5] However, the Board decided not to modify the lease accounting guidance for lessors, in part because it wants lessor accounting to remain substantially aligned with current U.S. GAAP.

Lessee Reassessment of Lease Classification. Under the proposed guidance, a lessee would reassess lease classification only if the lease is modified and the modification is not accounted for as a separate lease. A reassessment of the lease term would not cause a lessee to reassess lease classification. A reassessment could occur because the lessee elects to exercise a renewal option provided in the original lease or because the lessee constructs significant leasehold improvements that make it reasonably certain the lessee will exercise a renewal or purchase option.

The Board decided that when a lessee reassesses the lease term or a lessee option to purchase the underlying asset, it would be required to reassess lease classification. This requirement also would apply when the lease term or likelihood of purchase option exercise changes as a result of a lease modification. This issue was relevant only for lessees because lessors would not reassess the lease term or a lessee purchase option consistent with current U.S. GAAP.

KPMG Observations

The decisions by the Board to consider the lease term an attribute of the lease and to require a reassessment of lease classification in more situations than under the previously proposed guidance would remove the significant accounting differences between the lease modification and lease reassessment guidance that could have created structuring opportunities.

The Board's decision not to change the lessor lease modification guidance is consistent with feedback it received that the lessor accounting model under current U.S. GAAP essentially is not broken and should not be fundamentally changed. It is another example of the disconnect that will exist between lessee and lessor accounting under the new leases standard.

Recognition of Initial Direct Costs in Sales-Type Leases

At their May 2014 joint Board meeting, the FASB and IASB decided that initial direct costs should include only incremental costs that an entity would not have incurred if the lease had not been obtained (executed). This is a change from the current U.S. GAAP definition to conform to the contract cost deferral guidance in ASC Subtopic 340-40.[6] In addition, the FASB decided that a lessor would not capitalize initial direct costs for leases in which the customer effectively obtains

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[5] ASC Topic 606, Revenue from Contracts with Customers, available at www.fasb.org.

[6] ASC Subtopic 340-40, Other Assets and Deferred Costs – Contracts with Customers, available at www.fasb.org.

control of the underlying asset through the lease (i.e., a sales-type lease).[7] Instead, a lessor would recognize as an expense initial direct costs associated with those leases at lease commencement.

Constituents that commented on the external review draft noted that the draft guidance on initial direct costs would change the timing of expense recognition for lessors such as banks that function as financing intermediaries. Under current U.S. GAAP those lessors classify leases in which the customer effectively obtains control of the underlying asset through the lease as direct financing leases or leveraged leases when the lease does not give rise to selling profit or loss. Under either classification, initial direct costs are deferred and amortized over the lease term. Some external reviewers questioned whether the external review draft guidance was consistent with the FASB's expressed intent not to significantly change lessor accounting.

At its October 7 meeting, the Board decided to require initial direct costs incurred as a result of entering into a sales-type lease to be deferred and recognized over the lease term *if there is no selling profit or selling loss* (excluding consideration of the initial direct costs) on the lease. This would result in recognition outcomes that are generally consistent with current U.S. GAAP.

KPMG Observations

The Board's revised decision on lessor accounting for initial direct costs is consistent with ASC Subtopic 340-40, which requires deferred contract costs to be recognized in the income statement on the same basis as the transfer to the customer of the goods or services to which the costs relate. This occurs because lessors that enter into sales-type leases in which there is no selling profit or loss in effect provide a financing service to the customer (lessee).

In addition, the Board's decision is consistent with its desire not to substantially change lessor accounting, and it would retain convergence in the accounting for initial direct costs with the forthcoming IFRS guidance on leases.

Lessor Presentation of Its Net Investment in the Lease

The FASB revisited its previous decision to permit lessors to separately present the components of the net investment in leases other than operating leases either in the statement of financial position or in the notes to the financial statements. Those components comprise the lease receivable, unguaranteed residual value, and deferred selling profit (if applicable). The FASB did not previously decide that lessors would be required to separately present the total net investment in leases other than operating leases in the statement of financial position. The Board's discussion was primarily in response to concerns expressed by external reviewers about complexities within the lessor

[7] The Board referred to these leases as sales-type leases, although they were referred to as Type A leases in the 2013 Exposure Draft.

presentation requirements and a potential lack of consistency with some of the Board's other lessor accounting decisions.

The Board decided to require lessors to separately present the net investment in leases other than operating leases on the face of the statement of financial position. The Board acknowledged that disaggregated information on the components of the net investment is beneficial for the financial statement users, and decided to require lessors to disclose the components of the net investment without specifying where that information should be provided in the financial statements. Consequently, lessors would have the flexibility to disclose the components of the net investment in the statement of financial position or the notes to the financial statements.

Private Company Council Considerations

At their July 2015 meeting, Private Company Council (PCC) members raised continuing concerns about the FASB's lease accounting proposals including:

- ***Recognition of Leases on the Balance Sheet and the Lessee Accounting Model.*** The PCC requested that nonpublic lessees be required to recognize lease assets and liabilities only when the lessee is expected to consume more than an insignificant portion of the underlying asset. For leases that do not qualify for on-balance sheet accounting, lessees would recognize lease expense generally on a straight-line basis, similar to the accounting for operating leases under current U.S. GAAP.
- ***Presentation of Lease Assets and Liabilities on the Balance Sheet.*** If the final leases standard will require lessees to recognize all leases (other than short-term leases) on the balance sheet, the PCC recommended that, for nonpublic lessees, the lease asset and liability be presented in a linked manner, or adjacent to each other, on the balance sheet. Therefore, only the net amount of the lease asset and liability would affect the lessee's assets or liabilities on the balance sheet.

At its October meeting, the FASB decided not to provide different recognition or presentation requirements for nonpublic companies. In the Board's view, all leases give rise to a lease asset and liability for lessees, and the new guidance should extend to both public and nonpublic companies. Additionally, the Board believes that allowing linked presentation is beyond the scope of the leases project, and would require significant time to sufficiently address.

Under the Board's previous decisions, a nonpublic company may elect to use a risk-free discount rate as the lessee's incremental borrowing rate. The Board decided that this is the only exception that will be provided solely for nonpublic companies in the final leases standard.

Next Steps

The Board will meet early in November to discuss effective date and cost-benefit considerations. Based on the outreach performed and feedback received by the FASB throughout this project, including financial statement users' expressed desire for better information in lessees' financial statements and the FASB's attempts to minimize process and system changes where possible, the Board expects to issue its final leases standard by the end of 2015.

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

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Summary of Decisions Reached in Redeliberations

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td>Definition of a Lease</td><td colspan="2">• A contract will contain a lease if:
– Fulfillment of the contract depends on the use of an identified asset, and
– The contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration, or neither the customer nor the supplier controls the use of the identified asset throughout the period of use, and
• The customer has the right to operate the asset (and the supplier has no right to change those operating instructions) throughout the period of use, or
• The customer designed the asset, or caused it to be designed, in a way that predetermines during the period of use how and for what purpose it will be used</td></tr>
<tr><td rowspan="2">Practical Expedients and Targeted Reliefs</td><td colspan="2">• Optional lessee exemption for short-term leases – i.e., leases with a lease term of ≤ 12 months
• Portfolio-level accounting will be permitted if it does not differ materially from applying the requirements to individual leases (e.g., discount rate or lease term)</td></tr>
<tr><td>• No exemption for leases of low-value assets</td><td>• Optional lessee exemption for leases of low-value assets (e.g., leases of assets with a value of $5,000 or less when new), even if material in aggregate</td></tr>
<tr><td>Lessee Accounting Model</td><td>• Dual-lease accounting model
• Lease classification test based on classification criteria under current IFRS on leases[8]
• All leases on-balance sheet: lessee will recognize a right-of-use (ROU) asset and lease liability
– Finance leases will be treated as the purchase of an asset on a financed basis
– Operating leases generally will have straight-line recognition of total lease cost</td><td>• Single lease accounting model
• No lease classification test
• All leases on-balance sheet: lessee will recognize a right-of-use (ROU) asset and lease liability
– Treated as the purchase of an asset on a financed basis</td></tr>
</table>

[8] IAS 17, Leases.

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td rowspan="4">Lessor Accounting Model</td><td colspan="2">• Dual lease accounting model
• Lease classification test based on IAS 17 classification criteria
• Operating lease accounting model based on current IFRS operating lease accounting[9]</td></tr>
<tr><td>• Sales-type and direct financing lease accounting model based on current U.S. GAAP accounting for sales-type and direct financing leases with recognition of net investment in lease comprising lease receivable and residual asset[10]</td><td>• Finance lease accounting model based on current IFRS finance lease accounting with recognition of net investment in lease comprising lease receivable and residual asset</td></tr>
<tr><td>– Selling profit will not be recognized on commencement of leases that qualify as direct financing leases, even if the carrying amount and fair value of the underlying asset are different</td><td>– There will be no restriction on recognizing selling profit on commencement for finance leases</td></tr>
<tr><td>• Existing leveraged leases will be grandfathered and exempt from applying the new standard</td><td>• N/A – leveraged lease accounting does not exist under IFRS</td></tr>
<tr><td>Related-Party Leasing Transactions</td><td>• Account for leases between related parties based on their contractual terms, even if they differ from the substance of the arrangement
• Disclose lease transactions between related parties</td><td>• N/A – the IASB did not address related-party leasing transactions in its proposals</td></tr>
<tr><td>Lease Term and Purchase Options</td><td colspan="2">• Payments for optional (e.g., renewal) periods and purchase options will be included in lease accounting if it is reasonably certain that the lessee will exercise those options, consistent with the high threshold in current U.S. GAAP
• Lessees will reassess renewal and purchase options if there is a significant event or change in circumstances that is within the control of the lessee – e.g., construction of significant leasehold improvements
• No reassessment of renewal and purchase options by lessors</td></tr>
</table>

[9] Operating leases were referred to as Type B leases in the 2013 Exposure Draft.

[10] Sales-type and direct financing leases were referred to as Type A leases in the 2013 Exposure Draft.

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td>Initial Direct Costs</td><td colspan="2">• Initial direct costs will include only incremental costs that an entity would not have incurred if it had not obtained the lease (e.g., commissions or payments made to existing tenants to obtain the lease)
• Lessees will include initial direct costs in the initial measurement of the ROU asset and amortize the costs over the lease term
• Initial direct costs will be included in determining the lessor's implicit rate unless the lease is a sales-type lease for which there is a selling profit or loss recognized at lease commencement (in which case initial direct costs will be expensed)
• Lessors will include initial direct costs for:
– Sales-type leases in the initial measurement of the lease receivable unless there is a selling profit (loss) on the lease, in which case initial direct costs will be expensed at lease commencement, and
– Direct financing leases in the initial measurement of the lease receivable
• Lessors will capitalize initial direct costs for operating leases and amortize the costs over the lease term in the same pattern as lease income</td></tr>
<tr><td rowspan="3">Discount Rate</td><td colspan="2">• The lessee's discount rate will be the lessor's implicit rate if available, otherwise, the lessee's incremental borrowing rate
– The value used to determine the lessee's incremental borrowing rate will be the cost of the ROU asset
• Lessees will reassess the discount rate when there is:
– A change in the lease term or the assessment of whether the lessee is, or is not, reasonably certain to exercise a purchase option, and
– A lease modification</td></tr>
<tr><td>• Nonpublic business entity lessees will be permitted to elect as an accounting policy to use a risk-free discount rate</td><td>• N/A – no unique guidance for nonpublic business entities</td></tr>
<tr><td colspan="2">• The lessor's discount rate will be the rate implicit in the lease (i.e., the implicit rate)
– Initial direct costs will be included in determining the implicit rate unless the lease is a sales-type lease for which a selling profit or loss is recognized at lease commencement
• Lessors will reassess the discount rate when there is a lease modification</td></tr>
</table>

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td rowspan="2">Variable Lease Payments</td><td colspan="2">• Lease payments used in the initial measurement of lease assets and liabilities will include:
– Variable payments based on an index or rate using prevailing (spot) rates or indices at lease commencement, and
– Variable payments that represent in-substance fixed payments (consistent with current practice)
• No reassessment of variable lease payments by lessors
• Variable payments that are not based on an index or rate and are not in-substance fixed payments will be excluded from the measurement of lease assets and liabilities and recognized as expense as incurred or income as earned</td></tr>
<tr><td>• Lessees will reassess variable lease payments based on an index or rate only when lease payments are remeasured for other reasons (e.g., a reassessment due to a change in the lease term)</td><td>• Lessees will reassess variable lease payments based on an index or rate when:
– Lease payments are remeasured for other reasons (e.g., a reassessment due to a change in the lease term)
– There is a contractual change in the cash flows (i.e., when an adjustment to the lease payments based on an index or rate takes effect under the terms of the lease)</td></tr>
<tr><td>Arrangements with Lease and Non-lease Components; Contract Combinations</td><td colspan="2">• Activities (or costs of the lessor) that do not transfer a good or service to the lessee (e.g., taxes and insurance on the property) will be considered part of the lease (i.e., not separate components in a contract)
• Lessors will always separate lease and non-lease components and allocate consideration using the new revenue standard's guidance (i.e., on a relative stand-alone selling-price basis)
– Reallocate consideration when there is a contract modification that is not accounted for as a separate, additional lease
• Lessees will choose an accounting policy by class of underlying asset to either:
– Separate lease and non-lease components and allocate consideration based on relative stand-alone prices of components, maximizing the use of observable information
• Reallocate consideration when: (a) there is a reassessment of either the lease term or whether exercise of a lessee purchase option is reasonably certain, or (b) there is a contract modification that is not accounted for as a separate, additional lease</td></tr>
</table>

Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
	– Account for lease and non-lease components together as a single lease component • Two or more contracts entered into at or near the same time will be combined into a single transaction if: – The contracts are negotiated as a package with a single commercial objective, or – The amount of consideration to be paid in one contract depends on the price or performance of the other contract	
Lease Modifications	• Lease modifications will be defined as *any* change to the contractual terms and conditions of a lease that was not part of the original terms and conditions • A modification will be considered a separate lease when it grants the lessee an additional ROU that was not included in the original lease and that ROU is priced commensurate with its stand-alone price in the context of that particular contract • For lessees, when a modification is not considered a separate, additional lease: – If the modification does not reduce the lessee's ROU (e.g., right to use the leased asset for an additional time period), the ROU asset will be adjusted by the amount of the adjustment to the lease liability – If the modification reduces the lessee's ROU, the modification will be treated as a full or partial early termination of the lease with a resulting income statement effect • For lessors, when a modification is not considered a separate, additional lease: – Operating lease modifications will be treated as a new lease, and • If the modified lease is a sales-type or direct financing lease, the lessor will adjust the discount rate so that the initial net investment in the modified lease is measured in accordance with the new standard, net of any prepaid or accrued rent • If the modified lease is an operating lease, the lessor will consider prepaid or accrued rent as part of the lease payments for the new lease – Finance lease modifications • If the modified lease is a sales-type or direct financing lease, the lessor will adjust the discount rate so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease[11]	

[11] The new leases standard will include specific guidance for how to account for a lease modification if the original lease is a direct financing lease and the modified lease is a sales-type lease.

<table>
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<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td></td><td colspan="2">• If the modified lease is an operating lease, the lessor will recognize the underlying asset at the carrying amount of the net investment in the original lease</td></tr>
<tr><td rowspan="2">Subleases</td><td colspan="2">• A lessee-sublessor will account for the head lease and the sublease as two separate contracts unless those contracts meet the contract combinations guidance
– The head lease will be accounted for in accordance with the requirements for lessee accounting
– The sublease will be accounted for in accordance with the requirements for lessor accounting
• A lessee-sublessor will not offset lease liabilities and assets arising from a head lease and sublease unless they meet the financial instruments requirements for offsetting in U.S. GAAP or IFRS as applicable
• A lessee-sublessor will not offset lease income from a sublease and lease cost from a head lease unless it meets the requirements for offsetting in other U.S. GAAP or IFRS (e.g., the new revenue standard)[12]</td></tr>
<tr><td>• A sublessor will consider the underlying asset rather than the ROU asset to be the leased asset in determining the classification of the sublease</td><td>• A sublessor will consider the ROU asset to be the leased asset in determining the classification of the sublease</td></tr>
</table>

[12] Members of both Boards believe it is unlikely that sublease income and head lease cost will qualify to be offset if the sublease is classified as an operating lease.

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td rowspan="6">Sale-Leaseback Transactions</td><td colspan="2">Determining Whether a Sale Has Occurred
• A sale-leaseback of the underlying asset will be recognized if the requirements for sale recognition in the new revenue standard are met. The existence of the leaseback will not, on its own, result in a conclusion that control of the asset has not been conveyed to the buyer-lessor.</td></tr>
<tr><td>• If the leaseback would be classified as a sales-type lease, then sale recognition will be precluded
• A repurchase option held by the seller-lessee in a sale-leaseback transaction will preclude sale recognition unless:
– The strike price to repurchase the asset is its fair market value at the date of option exercise, and
– The underlying asset is readily available and non-specialized</td><td>• N/A – single model approach for lessee accounting
• If the seller-lessee has a substantive repurchase option with respect to the underlying asset, sale recognition will be precluded</td></tr>
<tr><td colspan="2">• Both the seller-lessee and the buyer-lessor will account for a sale-leaseback transaction that does not qualify for sale accounting as a financing transaction</td></tr>
<tr><td colspan="2">Accounting for a Sale/Purchase
• A buyer-lessor will account for the purchase of an asset in a sale-leaseback transaction that qualifies for sale accounting consistent with the guidance that applies to the purchase of a nonfinancial asset
• A seller-lessee will account for any loss on a sale-leaseback transaction that qualifies for sale accounting consistent with the guidance that applies to any other sale</td></tr>
<tr><td>• Any gain recognized by a seller-lessee on a sale-leaseback transaction that qualifies for sale accounting will be measured consistent with the guidance that applies to any other sale, subject to any adjustment for off-market terms</td><td>• Any gain recognized by a seller-lessee on a sale-leaseback transaction that qualifies for sale accounting will be restricted to the amount that relates to the buyer-lessor's residual interest in the underlying asset, subject to any adjustment for off-market terms</td></tr>
</table>

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td rowspan="2"></td><td colspan="2">Accounting for the Leaseback
• If a sale-leaseback transaction qualifies for sale accounting, the leaseback will be accounted for in the same manner as any other lease</td></tr>
<tr><td colspan="2">Accounting for Off-market Terms
• Any potential off-market adjustment will be measured as the more readily determinable of:
– The difference between the fair value of the underlying asset and the sales price, or
– The difference between the present value of fair market value lease payments and the present value of the contractual lease payments
• A deficiency in the transaction terms versus market terms will be accounted for as a prepayment of rent
• An excess in the transaction terms versus market terms will be accounted for as additional financing provided by the buyer-lessor to the seller-lessee</td></tr>
<tr><td rowspan="2">Lessee Presentation – Balance Sheet</td><td colspan="2">• Lessees will present finance lease ROU assets and lease liabilities either as separate line items on the balance sheet or disclose them separately in the notes to the financial statements
– If not separately presented on the balance sheet, lessees will:
• Present finance lease ROU assets on the balance sheet as if the underlying asset were owned
• Disclose in the notes the line items on the balance sheet in which finance lease ROU assets and lease liabilities are included and their amounts</td></tr>
<tr><td>• Lessees will not include operating ROU assets and lease liabilities in the same line items as finance ROU assets and lease liabilities on the balance sheet
– If not separately presented on the balance sheet, lessees will disclose in the notes the line items on the balance sheet in which operating ROU assets and lease liabilities are included and their amounts</td><td>• N/A – no operating lease classification</td></tr>
</table>

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td>Lessee Presentation – Statement of Cash Flows</td><td>• Lessees will classify cash paid for:
– Principal on finance lease liabilities as financing activities
– Interest on finance lease liabilities in accordance with the requirements relating to interest paid under U.S. GAAP guidance on cash flows[13]
– Operating leases, variable lease payments, and leases that are not recognized on-balance sheet (e.g., some short-term leases) as operating activities</td><td>• Lessees will present cash paid for:
– Principal on lease liabilities as financing activities
– Interest on lease liabilities as either operating or financing activities based on the lessee's accounting policy choice under IFRS guidance on cash flows[14]
– Variable lease payments and leases that are not recognized on-balance sheet (e.g., some short-term leases) as operating activities
• Lessees will disclose total lease payments in the notes to the financial statements</td></tr>
<tr><td rowspan="2">Lessee Disclosures</td><td colspan="2">• Objective: Enable financial statement users to understand the amount, timing, and uncertainty of cash flows arising from leases</td></tr>
<tr><td>• Lessees will disclose the following qualitative information:
– Nature of leases (and subleases)
– Leases that have not yet commenced, but that create significant rights/obligations
– Significant lease accounting judgments and assumptions
– Main terms and conditions of sale-leaseback transactions
– Whether an accounting policy election was made for the short-term lease exemption</td><td>• Lessees will disclose other information, in addition to the quantitative disclosures, in sufficient detail to satisfy the lessee disclosure objective</td></tr>
</table>

[13] FASB ASC Topic 230, Statement of Cash Flows, available at www.fasb.org.

[14] IAS 7, Statement of Cash Flows.

Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
	• Lessees will disclose the following *quantitative* information:	
	In any format the lessee considers appropriate	In a tabular format, unless another format is more appropriate
	– Amortization of ROU assets and interest on lease liabilities (including capitalized interest)	
	• For finance leases only – N/A	• Amortization split by class of underlying asset – Additions to ROU assets – Carrying amount of ROU assets, split by class of underlying asset
	– Short-term lease cost (when lease term > 30 days) – Variable lease cost – Sublease income – Gains (losses) on sale-leaseback transactions	
	– Operating lease cost – N/A – Cash paid for lease payments, separately for finance and operating leases and segregated between operating and financing cash flows – Supplemental noncash information on lease liabilities exchanged for ROU assets, separately for finance and operating leases – Weighted-average remaining lease term, separately for finance and operating leases – Weighted-average discount rate as of the balance sheet date, separately for finance and operating leases	– N/A – Expense relating to leases of low-value assets – Total cash outflow for leases – N/A

Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
	– A maturity analysis of lease liabilities for each of the first five years after the balance sheet date and in total thereafter, including a reconciliation of undiscounted cash flows to lease liabilities on the balance sheet	– A maturity analysis of lease liabilities in accordance with IFRS guidance on financial instruments, separate from the maturity analysis for other financial liabilities[15]
Lessor Presentation	• Lessors will present lease assets and liabilities and income and expense generally consistent with the current IFRS guidance on leases • Lessors will classify all cash inflows from leases as operating activities in the statement of cash flows	
Lessor Disclosures	*General* • A lessor will disclose the following information about its leases: – A general description of its leases – The basis, and terms and conditions, on which variable lease payments are determined – The existence, and terms and conditions, of options to extend or terminate the lease – The existence, and terms and conditions, of options for a lessee to purchase the underlying asset – Information about the significant assumptions and judgments made in accounting for its leases, which may include: • The determination of whether a contract contains a lease • The allocation of the consideration in contracts that contain a lease between lease and non-lease components • The initial measurement of the residual asset • Information about managing the risk associated with the residual asset – A table of lease income received during the reporting period – A maturity analysis of (a) the undiscounted cash flows comprising a lessor's lease receivables (for sales-type and direct financing leases), and (b) the undiscounted future lease payments (for operating leases) for each of the first five years and a total thereafter	

[15] IFRS 7, Financial Instruments: Disclosures.

<table>
<tr><th colspan="3">Redeliberations of 2013 Exposure Drafts</th></tr>
<tr><th>Topic</th><th>FASB Decisions</th><th>IASB Decisions</th></tr>
<tr><td></td><td colspan="2">• For sales-type and direct financing leases, the amounts included in the maturity analysis will be reconciled to the balance of lease receivables presented separately in the balance sheet or disclosed separately in the notes. A lessor will present the operating lease maturity analysis separately from the maturity analysis required for sales-type and direct financing leases.</td></tr>
<tr><td></td><td colspan="2">Operating Leases
• General property, plant, and equipment disclosures for assets subject to operating leases by significant class of underlying asset separately from those disclosures for the lessor's other owned assets</td></tr>
<tr><td></td><td>Direct Financing Leases</td><td>Finance Leases</td></tr>
<tr><td></td><td>• An explanation of the significant changes in the balance of unguaranteed residual assets and deferred selling profit</td><td>• A qualitative and quantitative explanation of the significant changes in the net investment in finance leases during the reporting period</td></tr>
<tr><td>Lessee Transition</td><td>• Modified retrospective transition:
– Required for all leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements
– Will not require transition accounting for leases that expired prior to the date of initial application</td><td>• Full retrospective approach or modified retrospective approach:
– Under the modified retrospective approach, a lessee will not restate comparative information
– At initial application date, recognize the cumulative effect of application as an adjustment to the opening balance of retained earnings (or other equity component as appropriate)</td></tr>
<tr><td></td><td>• Lessees may elect certain specified reliefs, which must be elected as a package and applied to all leases.</td><td>• N/A</td></tr>
<tr><td></td><td>• Lessees may use hindsight in evaluating whether payments for lease renewals and purchase options should be included in lease payments when accounting for existing leases. This practical expedient may be elected separately or in conjunction with</td><td>• N/A</td></tr>
</table>

Redeliberations of 2013 Exposure Drafts		
Topic	**FASB Decisions**	**IASB Decisions**
	the package of specified reliefs, and must be applied to all leases	
Lessor Transition	• Modified retrospective transition – Required for all leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements – Will not require any transition accounting for leases that expired prior to the date of initial application	• Continue to apply existing accounting for any leases that are ongoing at the date of initial application, except for intermediate lessors in a sublease • Intermediate lessors in subleases reassess each ongoing operating sublease at the date of initial application to determine whether under the new standard it is classified as an operating lease or a finance lease, based on the remaining contractual terms of the head lease and the sublease • For subleases that were classified as operating leases under current IFRS guidance on leases, but finance leases under the new standard, account for the sublease as a new finance lease entered into on the date of initial application
	• Lessors may elect certain specified reliefs, which must be elected as a package and applied to all leases	• N/A
	• Lessors may use hindsight in evaluating whether payments for lease renewals and purchase options should be included in lease payments when accounting for existing leases. This practical expedient may be elected separately or in conjunction with the package of specified reliefs, and must be applied to all leases	• N/A

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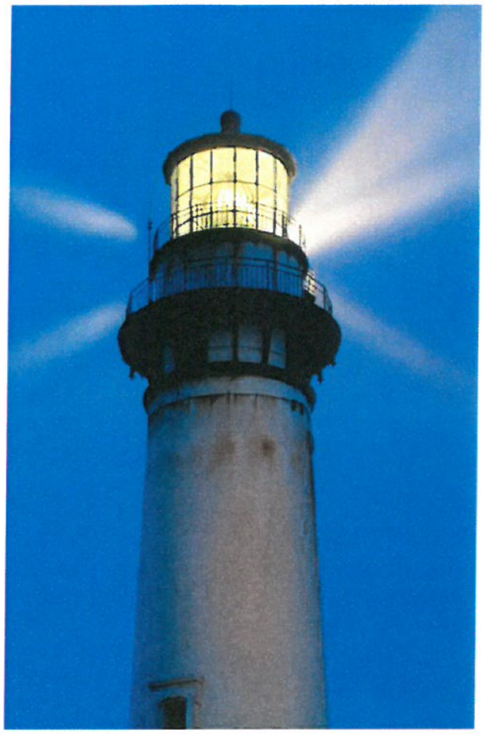
July 2015, No. 15-30



FASB Finalizes One-Year Deferral of the Revenue Standard

At its July 9, 2015 meeting, the FASB agreed to defer by one year the mandatory effective date of its revenue recognition standard, but will also provide entities the option to adopt it as of the original effective date.[1]

Contents

Key Facts

The FASB agreed to the following mandatory effective dates for its revenue standard:

- Public business entities and certain not-for-profit entities[2] will be required to adopt the revenue recognition standard in annual reporting periods beginning after December 15, 2017, and interim periods within those annual periods.
- All other entities will be required to adopt the standard in annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019.
- Early application will be permitted for all entities, but not before the original effective date for public business entities (i.e., annual reporting periods beginning after December 15, 2016).
- The option to use either a retrospective or cumulative-effect transition method will not change.

Key Impacts

Entities that elect to wait for the new effective date to adopt the standard will have an extra year to more effectively implement changes to their accounting systems, processes, and internal controls.

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[1] FASB Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers, available at www.fasb.org.

[2] This includes not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

Background

In response to the FASB's exposure draft[3] and other outreach activities, many stakeholders indicated that additional time is needed to develop accounting policies, update information technology systems, and change processes and internal controls.[4] More time also is required to consider the effect on taxes, contracts, and debt covenants, and to train employees.

In addition to the systems and policy concerns, the FASB was influenced by its ongoing consideration of potential amendments to make the standard more operational and limit the potential for diversity to develop in practice.[5] In the February and March 2015 joint FASB/IASB meetings, the FASB agreed to propose several amendments to its standard.

The IASB issued an exposure draft on May 19, 2015 that also proposes a one-year deferral of its revenue recognition standard.[6] The comment period on that proposal ended on July 3, 2015. Based on comment letters received, the IASB's constituents generally support a one-year deferral. The IASB's final decision on whether to defer its standard is expected at its scheduled meeting during the week of July 20.

Deferral Decision

The FASB agreed to defer by one year the mandatory effective date of the standard despite requests by some constituents for a longer deferral. The Board concluded that a one-year deferral is sufficient, in part because it expects standard-setting to be substantially complete by the end of 2015. Also, the Board indicated that deferring for more than one year could delay the implementation process and decrease comparability from a convergence standpoint. A deferral period of more than one year also would result in a longer period of non-comparability among U.S. GAAP preparers between early adopters and those adopting at the mandatory date.

The following chart summarizes the effective date for public business entities and certain not-for-profit entities with calendar year-ends versus the effective date for other entities with calendar year-ends:

Year-end	Mandatory Adoption Date	Early Adoption Date
Public business entities and certain not-for-profit entities		
December 31	January 1, 2018 (including the quarter ending March 31, 2018)	January 1, 2017 (including the quarter ending March 31, 2017)

[3] FASB Proposed Accounting Standards Update, Revenue from Contracts with Customers: Deferral of the Effective Date, April 29, 2015, available at www.fasb.org.

[4] See KPMG's Defining Issues Nos. 15-12 and 15-25, available at www.kpmginstitutes.com.

[5] See KPMG's Defining Issues Nos. 15-5 and 15-11, available at www.kpmginstitutes.com.

[6] IFRS 15, Revenue from Contracts with Customers.

Year-end	Mandatory Adoption Date	Early Adoption Date
Nonpublic entities		
December 31	January 1, 2019 (with mandatory application for interim reporting for the first interim period ending after January 1, 2020 and the option to apply it to the first interim period ending after January 1, 2019)	January 1, 2017 (with the option to apply it in the first interim period ending after January 1, 2017 or the first interim period ending after January 1, 2018), or January 1, 2018 (with the option to apply it in the first interim period ending after January 1, 2018 or the first interim period ending after January 1, 2019)

Next Steps

SEC registrants with calendar year-ends that plan to adopt the standard on January 1, 2018 using the retrospective transition method will present 2016–2018 information under the new revenue recognition standard. Until the period of adoption, SEC registrants will need to update their disclosures regarding plans for adopting the standard including when they plan to adopt and how they plan to transition as their plans become more concrete.[7] Entities should use the additional time to ensure their information technology systems are appropriately capturing the information needed for reporting and disclosure purposes.

Many entities will need to make modifications to their accounting policies, information technology systems, business processes, and internal controls before the effective date. They should use the additional time provided by the deferral to continue their implementation efforts.

Entities should monitor future developments as the Boards continue to explore clarifying amendments for certain aspects of the standard. Entities also will need to consider issues identified in future meetings of the Transition Resource Group for Revenue Recognition.

Contributing authors: Brian K. Allen, Prabhakar Kalavacherla, Paul H. Munter, Brian J. Schilb, and Maricela Frausto

Earlier editions are available at: http://www.kpmg-institutes.com

[7] SEC Staff Accounting Bulletin Topic 11.M, Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period, available at www.sec.gov.

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November 2015, No. 15-56

FASB Proposes to Clarify the Definition of a Business

Responding to stakeholder feedback, the FASB is proposing a new framework to determine whether a set of assets and activities is a business, which would narrow the current definition.[1]

Key Facts

Under the proposed Accounting Standards Update (ASU), an integrated set of activities and assets (a set) is a business if it has, at a minimum, an input and a substantive process that together contribute to the ability to create outputs. The proposal includes an initial screening test (A) that reduces the population of potential businesses before an entity analyzes whether there is an input and a substantive process in the set (B). The following is an overview.

A **Is substantially all of the fair value of the gross assets acquired concentrated in a single (group of similar) identifiable asset(s)?**

If yes, the set is not a business. If no...

B **Evaluate whether an input and a substantive process exist... Does the set have outputs?**

If yes...	**If no...**
The set is a business if it includes: • Organized workforce with skills, knowledge, or experience critical to continue producing outputs; • Process that cannot be replaced without significant cost, effort, or delay; **or** • Process that is considered unique or scarce.	The set is a business if it includes: • Organized workforce with skills, knowledge, or experience to perform an acquired process (group of processes) that, when applied to other acquired input(s), is critical to the ability to develop or convert the acquired input(s) into outputs.

Key Impact

Industries that are likely to be most affected are real estate, life sciences, and extractive, with fewer transactions being identified as acquiring or selling a business.

Contents

[1] Proposed Accounting Standards Update, Clarifying the Definition of a Business, November 23, 2015, available at www.fasb.org.

Scope Broader Than Acquisitions

Consideration of the proposal is likely to focus on the acquisition of a business.

However, the definition of a business affects many areas of accounting and financial reporting, including acquisitions and disposals, and the applicability of the variable interest entity consolidation requirements.

Why Does the Definition of a Business Matter?

Some of the differences in accounting for the acquisition of a business versus a group of assets may be significant. Examples of these differences follow.

Asset	Business
Initial Measurement	
Purchase price allocated on a relative fair value basis. No goodwill or bargain purchase gain (see below) is recognized.	Identifiable assets and liabilities generally measured at fair value. Goodwill or bargain purchase gain may be recognized.
Direct Acquisition-Related Costs	
Capitalized and included in purchase price.	Generally expensed as incurred.
Bargain Purchase Amount	
Allocated to identifiable nonfinancial assets and liabilities on a relative fair value basis.	Recognized immediately in earnings as a gain.
Contingent Consideration	
Not recognized until contingency is resolved.	Recognized at the acquisition date fair value. Subsequent changes to the fair value of liability-classified contingent consideration are recognized in earnings.
In-Process R&D	
Purchase price allocated to in-process R&D and then expensed unless it has an alternative future use.	Capitalized at fair value and accounted for as an indefinite-lived intangible asset until completion or abandonment of the project.

Examples That Illustrate the Proposal

Some Assets Could Be Grouped in Applying the Screening Test

In applying the screening test (A), a single identifiable asset generally would include any identifiable asset or group of assets that could be recognized and measured as a single identifiable asset in a business combination (e.g., complementary intangible assets that have similar useful lives).

Examples of assets that generally would not be combined include tangible and intangible assets; identifiable intangible assets in different major intangible asset classes; financial and nonfinancial assets; different major classes of financial assets; and different major classes of tangible nonfinancial assets.

Example 1: Real Estate[2]

Facts

- REIT purchases all of the outstanding shares of Building Co. from Seller.
- Building Co. holds a multi-tenant corporate office park with six 10-story office buildings leased to maximum occupancy. Seller manages its properties centrally and manages the operations of Building Co. with its own employees.
- REIT acquires the land, buildings, and in-place leases (at market), and assumes vendor contracts for outsourced cleaning and security. Seller's employees that perform leasing (e.g., sales and underwriting), tenant management, financing, and other strategic management processes are not acquired.
- REIT plans to replace the property management and employees with its own internal resources.

Analysis

A REIT first considers whether substantially all of the fair value of the gross assets acquired is concentrated in a single (or group of similar) identifiable asset(s). Although the in-place leases are at market value, REIT concludes that their fair value is significant and that the fair value of the gross assets acquired is not concentrated in either the leases or the tangible assets.

B The set has continuing revenues through the in-place leases, and therefore, has outputs. REIT concludes that the processes performed through the cleaning and security contracts (the only processes acquired) are considered ancillary or minor in the context of all of the processes required to create outputs in the real estate industry (i.e., leasing, tenant management, financing, and management of building operations). REIT also concludes that the cleaning and security processes could easily be replaced with little cost, effort, or delay, and are not considered unique or scarce.

Conclusion

The acquired set does not include both an input and a substantive process and, therefore, would not be considered a business.

KPMG Observations

Fewer real estate transactions would qualify as business acquisitions (as illustrated in Example 1) under the proposal than qualify today, but it may be difficult to determine whether assets are combined or considered similar in applying the screening test (A). There is limited guidance in the proposal beyond the examples, and judgment would be required.

[2] Based on Case H in the Proposed ASU.

Outputs Do Not Automatically Mean That There Is a Business

In Example 2, no revenue (outputs) is currently being generated.

However, if the acquired set does have outputs, a continuation of revenues generated from an acquired set would not, on its own, indicate that a substantive process has been acquired (see Example 1). Therefore, assumed contractual arrangements that provide for the continuation of revenues (e.g., customer contracts, customer lists, and leases when the set is the lessor), would be excluded from determining whether there is a substantive process.

In addition, the definition of outputs would be amended to align better with the new revenue standard, focusing on providing "goods or services to customers, other revenues, or investment income, such as dividends or interest..."[4]

Example 2: Life Sciences[3]

Facts

- Pharma Co. buys all of the outstanding shares of Target Biotech.
- Target Biotech's operations include R&D activities on several preclinical compounds that it is developing (in-process R&D projects).
- Pharma Co. acquires the scientists who have the necessary skills, knowledge, or experience to perform R&D activities.
- Target Biotech has long-lived tangible assets such as corporate headquarters, a research lab, and testing equipment.
- Target Biotech does not yet have a marketable product and, therefore, has not generated revenues.

Analysis

A

Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single (or group of similar) identifiable asset(s).

This is because the fair value of the gross assets is not concentrated but rather spread across a number of items, both tangible (the corporate headquarters, a research lab, and testing equipment) and intangible (the in-process R&D projects plus the acquired workforce). These assets are not similar for the purpose of applying the screening test.

B

Pharma Co. concludes that the scientists make up an organized workforce that has the necessary skills, knowledge, or experience to perform processes that, when applied to the in-process R&D inputs, are critical to the ability to develop those inputs into outputs.

Conclusion

The set includes both inputs and substantive processes and would be a business.

KPMG Observations

The proposal includes a number of examples to help constituents understand how the FASB intends its framework to be applied. The examples cover a variety of industries and transactions not covered in this *Defining Issues*, including oil and gas, manufacturing, and the acquisition of intellectual property and single-family homes.

[3] Based on Case E in the Proposed ASU.

[4] FASB Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers, available at www.fasb.org.

Proposed Transition and Effective Date

An entity would apply the proposal prospectively to transactions that occur on or after the effective date. The Board will determine the effective date and consider whether to permit early adoption after it receives stakeholder feedback. No disclosures would be required at transition.

Convergence

The proposal would create a new difference between U.S. GAAP and IFRS because the current definition of a business under U.S. GAAP is converged with the IFRS definition. However, stakeholder feedback obtained by the FASB indicated that the definitions are applied differently under U.S. GAAP and IFRS, with the definition being applied more broadly under U.S. GAAP.

KPMG Observations

The IASB's recent post-implementation review of its standard on business combinations revealed stakeholder concerns about the challenges in applying the definition of a business.[5]

In October 2015, the IASB discussed the definition of a business and tentatively decided to propose changes to IFRS 3 that are the same as the amendments proposed by the FASB. In November 2015, the IFRS Interpretations Committee confirmed that issuing an amendment similar to the FASB's proposal would help resolve practical problems under IFRS.

Next Steps

Comments on the proposed ASU are due by January 22, 2016. The FASB will review the comments and determine whether to finalize the ASU as proposed.

The FASB's project to clarify the definition of a business includes two additional phases that remain under discussion, with no time frame for issuing exposure drafts. The first phase relates to partial sales or transfers of, and the corresponding acquisition of partial interests in, a nonfinancial asset or assets. The second phase relates to aligning the recognition and measurement guidance for assets versus businesses.

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

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[5] Post-implementation Review of IFRS 3 Business Combinations – Report and Feedback Statement, available at www.ifrs.org.

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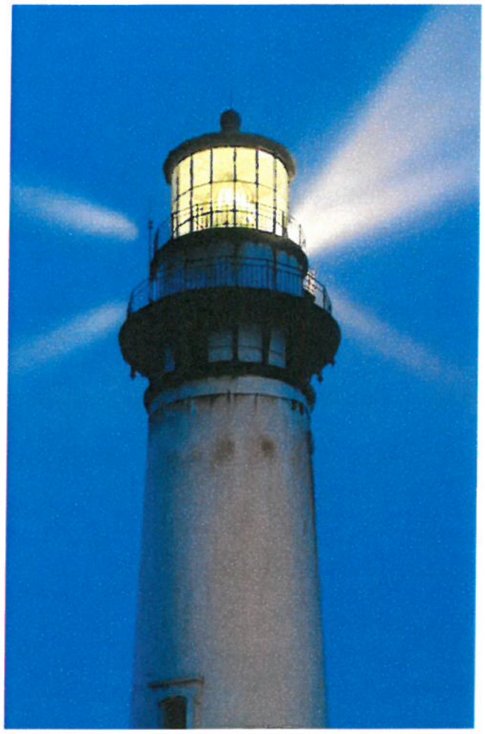
September 2015, No. 15-44



Contents

FASB Proposes Further Amendments to Revenue Standard

The FASB invited constituents to comment on a proposed Accounting Standards Update (ASU) intended to clarify the application of the new revenue standard with respect to the guidance on collectibility, the date to measure noncash consideration, presentation of sales taxes, and transition.[1] The comment deadline is November 16, 2015.

Key Facts

The FASB is proposing amendments to:

- Clarify when to recognize revenue for nonrefundable consideration received before collectibility of the entire amount to which the entity expects to be entitled is probable;
- Clarify the guidance on derecognition of an asset transferred to a customer;
- Specify for transition that a completed contract is one in which all (or substantially all) of the revenue has been recognized under current U.S. GAAP before the revenue recognition standard is adopted;
- Add a practical expedient that would not require the evaluation of each contract modification from contract inception through the date of adoption;
- Add a policy election to present taxes collected from customers on behalf of governmental authorities on a net basis; and
- Clarify that noncash consideration is measured at contract inception.

Key Impacts

- The FASB's objective with the proposed amendments is to make the standard more operational without significantly changing the underlying principles.
- The proposed FASB amendments are not expected to be considered by the IASB, which could result in differences between how the two Boards' revenue recognition standards are applied.[2]

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[1] FASB Proposed Accounting Standards Update, Narrow-Scope Improvements and Practical Expedients, available at www.fasb.org.

[2] IFRS 15, Revenue from Contracts with Customers.

Collectibility

The proposals clarify when to recognize revenue when collectibility is not probable.

The revenue standard specifies that a contract does not exist for purposes of the revenue recognition model (Step 1) unless collectibility of the consideration to which the entity expects to be entitled is probable.[3] This determination is based on the customer's ability and intention to pay the amount when due. Because Step 1 is a gateway to the revenue recognition model, no revenue is recognized when an entity concludes that collectibility is not probable. This prohibition on revenue recognition also applies to any nonrefundable consideration received. If collectibility of the entire amount to which the entity expects to be entitled is never deemed probable of being collected, the entity does not recognize revenue until either (1) the entity has no remaining performance obligations and substantially all of the consideration has been received and is nonrefundable, or (2) the contract is terminated and all amounts received are nonrefundable. These criteria are referred to as the "alternate recognition model."

The FASB's proposed amendments would add a third event to the alternate recognition model. Under the proposed additional event, when collectibility of the entire amount to which the entity expects to be entitled is not probable, an entity would recognize revenue in the amount of nonrefundable consideration received when the entity has transferred control of the goods or services, the entity has stopped transferring additional goods or services and has no obligation to transfer additional goods or services, and the consideration received from the customer to date is nonrefundable.

The FASB's proposed amendments would include implementation guidance and examples to illustrate the objective and application of the collectibility threshold. The FASB also is proposing to amend Example 1 in the revenue standard to clarify that assets are derecognized when control of the asset transfers to the customer. This may precede the point when revenue is recognized. In that case, the entity would recognize a loss when the asset is derecognized.[4]

Completed Contracts at Transition

Completed contract is redefined for purposes of applying the transition requirements.

An entity that applies the cumulative-effect transition approach when adopting the revenue recognition standard will apply it to contracts that are not completed as of the initial application date. Additionally, the application of certain practical expedients available to an entity that applies the full retrospective approach is impacted by the definition of a completed contract for transition purposes.

The transition guidance currently states that a contract is completed if the entity has *transferred* all of the goods and services identified under current U.S. GAAP. While the transfer of goods and services is a new concept in the revenue standard, it differs from the earned and realized notion embedded in much of legacy U.S. GAAP. This difference in underlying concepts may create transition difficulties because an entity may have transferred all of the goods and services to the customer but not yet recognized all of the revenue. This might occur, for

[3] FASB Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers, available at www.fasb.org. For additional examples on the proposed amendments and comparison to IASB's proposals, please see Defining Issues Nos.15-38, FASB to Clarify Revenue Standard's Collectibility and Completed Contracts Guidance, and 15-11, FASB and IASB to Propose Additional Revenue Clarifications, both available at www.kpmginstitutes.com.

[4] FASB ASC paragraphs 606-10-55-95 through 55-98, available at www.fasb.org.

example, when the amount due from the customer is not fixed or determinable at the date the goods and services were transferred to the customer.

The FASB's proposed amendments would redefine a completed contract for transition purposes as one for which all (or substantially all) of the revenue was recognized under legacy U.S. GAAP.

Example 1: Impact of Change in Definition of Completed Contract

A publicly traded, calendar year-end company sells products to distributors and regularly grants price concessions and accepts product returns. The company's accounting policy is to recognize revenue when the distributors sell the products to end customers (sell-through).

On December 15, 2017, the company delivers products to a distributor. On January 1, 2018, the company adopts the revenue standard using the cumulative-effect transition approach before the distributor has sold any products.

Absent the FASB's proposed amendments, the company likely would conclude that the contract is completed because control of the products has transferred to the distributor prior to the adoption date. As the distributor sells the products, the company receives cash. However, the standard is not clear on how the cash receipts should be accounted for. One interpretation would have required cash receipts to be recognized directly into equity.

Under the FASB's proposed amendments, the company concludes that the contract is not completed at the date of adoption because substantially all of the revenue had not been recognized under legacy U.S. GAAP. The company would apply the standard retrospectively to the contract. The new standard would result in revenue being recognized on December 15, 2017, after giving effect to the constraint on variable consideration. Therefore, the company would recognize a cumulative catch-up to equity on the date of adoption.

The FASB's proposed amendments also specify that an entity using the cumulative-effect transition approach would be permitted, but not required, to apply that transition approach to all contracts whether completed or not at the date of transition.

The IASB has not proposed similar amendments to IFRS 15. If the IASB and FASB do not remain converged on this transition topic, multi-national companies adopting the standard using the cumulative-effect approach could have different populations of contracts to which they apply the new standard. This could result in incremental efforts to adopt the standard for multi-national companies. Differences between a company's U.S. GAAP and IFRS financial statements could occur for a period of time even though the guidance in the standards is largely converged.

Practical Expedients upon Transition

The revenue standard requires that contract modifications are accounted for either prospectively or through a cumulative catch-up adjustment depending on the specific circumstances of the modification.

The FASB has proposed a practical expedient that would not require an evaluation of each contract modification from contract inception through the date of adoption. For an entity electing the practical expedient, modified contracts would be accounted for during transition by:

- Identifying all satisfied and unsatisfied performance obligations from inception of the original contract to the Contract Modification Adjustment Date (CMAD);
- Determining the transaction price based on the information available at the CMAD using total consideration to which the entity is entitled for all performance obligations (satisfied and unsatisfied) in the contract; and
- Allocating the transaction price to the performance obligations at the CMAD based on the historic stand-alone selling price of each good or service.

The beginning of the earliest period presented would be the CMAD under the retrospective transition approach. The date of initial application would be the CMAD under the cumulative-effect transition approach. Modifications occurring after the CMAD would be accounted for using the standard's contract modifications guidance.

The FASB's proposed amendments would not require an entity electing the retrospective transition approach to disclose the current period impacts of adopting the standard, which would have required an entity to account for contracts under both the standard and current U.S. GAAP in the period of adoption. This change would align the standard with IFRS.

Sales Tax Presentation: Gross versus Net

The standard supersedes current U.S. GAAP guidance that allows a policy election to present taxes collected from customers on behalf of governmental authorities either gross or net.[5] The standard requires a company to evaluate each tax in each jurisdiction in which it operates to determine whether taxes are amounts collected on behalf of third parties that would be excluded from the transaction price.

The FASB has proposed a practical expedient that would allow an entity to elect an accounting policy to present these taxes on a net basis. If the entity does not elect to apply the practical expedient, it would be required to analyze whether an individual tax should be included in the transaction price. An entity would be required to disclose its use of this practical expedient. The FASB decided to use the same scope that is in ASC paragraph 605-45-15-2(e), which includes sales, use, value added, and some excise taxes.

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[5] FASB ASC paragraphs 605-45-50-3 and 50-4, available at www.fasb.org.

Noncash Consideration

The revenue standard requires that noncash consideration be measured at fair value. If an entity cannot reasonably estimate the fair value of noncash consideration, it is measured indirectly by reference to the selling price of the goods or services promised to the customer. However, the standard does not specify *when* to measure noncash consideration at fair value. This differs from current U.S. GAAP where the measurement date of equity-based consideration is the earlier of the vesting date or the performance commitment date.[6]

The FASB's proposed amendments specify that noncash consideration be measured at contract inception. This is generally consistent with the measurement of the transaction price when it consists of cash consideration. The FASB is proposing to update Example 31 in the standard to be consistent with its decision on the measurement date.[7]

The FASB is also proposing that the constraint applies only to variability caused by reasons other than the form of the consideration. Determining whether a change in fair value was caused by the form of the noncash consideration or other reasons and deciding how to allocate changes between these reasons may be challenging.

Example 2: Application of the Constraint to Noncash Consideration

On January 1, 2018, Company A enters into a contract to provide services to Customer Z for one year. In exchange, Company A will receive 1,000 common shares of Customer Z on December 31, 2018. If Company A achieves a performance milestone, it will be entitled to an additional 200 shares.

Company A considers the factors associated with the constraint on variable consideration in determining whether it expects to be entitled to the additional shares. However, changes in the share price subsequent to the measurement date of January 1, 2018, is not variable consideration. Therefore, the constraint is not applied to those changes (i.e., variation due to the form of noncash consideration).

Next Steps

Companies should evaluate the FASB's proposed amendments and consider submitting a comment letter by the November 16, 2015, deadline.

[6] FASB ASC paragraph 505-50-30-18, available at www.fasb.org.

[7] FASB ASC paragraph 606-10-55-247, available at www.fasb.org.

Separately, the FASB previously issued its exposure draft on principal versus agent guidance with comments due by October 15, 2015.[8]

The FASB is expected to discuss the comment letters on its exposure draft on licenses and performance obligations in early October.[9]

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

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Earlier editions are available at: http://www.kpmg-institutes.com

[8] FASB Proposed Accounting Standards Update, Principal versus Agent Considerations (Reporting Revenue Gross versus Net), August 31, 2015, available at www.fasb.org.

[9] FASB Proposed Accounting Standards Update, Identifying Performance Obligations and Licensing, May 12, 2015, available at www.fasb.org.

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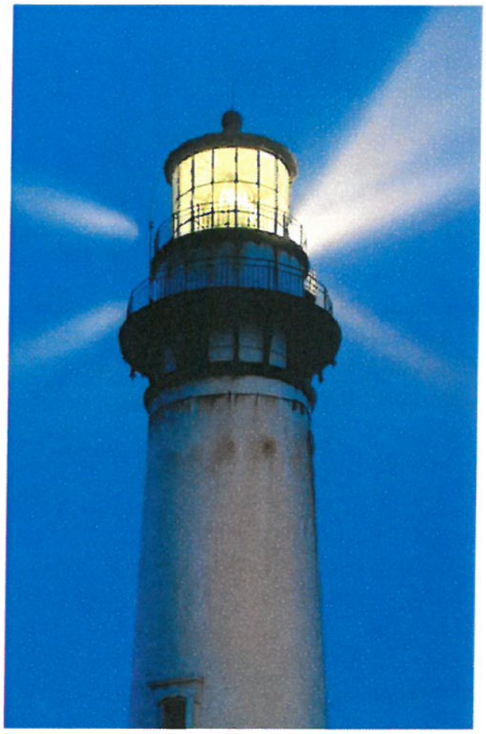

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FASB Redeliberates Revenue Guidance on Licensing and Performance Obligations

On October 5, 2015, the FASB redeliberated and, in general, tentatively decided to adopt its proposed revenue guidance on accounting for licenses of intellectual property and identifying performance obligations.[1] The redeliberations were held in response to comment letters on the FASB's proposed Accounting Standards Update (ASU) and its staff's outreach efforts.

Key Facts

The Board tentatively decided to:

- Clarify the timing of recognition for revenue from licenses of intellectual property (IP), including the guidance for sales- and usage-based royalties;
- Amend the criteria for determining whether goods or services are performance obligations;
- Specify that an entity is not required to identify as a performance obligation goods or services that are immaterial in the context of the contract;
- Add a policy election to account for shipping and handling services provided after control of the goods transfers to the customer as a fulfillment activity; and
- Retain the requirement that goods and services that meet specified criteria be accounted for as a series (i.e., a single performance obligation).

Key Impacts

- The FASB's amendments are not fully converged with the IASB's proposed amendments. However, the Boards hope that the wording differences will not result in significantly different outcomes in practice, excluding areas where the FASB has provided additional practical expedients (e.g., shipping and handling).[2] The IASB is proposing more limited clarifications to its standard. The comment deadline on the IASB's exposure draft is October 28, 2015.
- For entities that license IP, the timing of revenue recognition may be significantly different from current practice.

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[1] FASB Proposed Accounting Standards Update, Identifying Performance Obligations and Licensing, May 12, 2015, available at www.fasb.org.

[2] IASB Exposure Draft ED/2015/6, Clarifications to IFRS 15, available at www.ifrs.org.

The Board's clarifications to determining the nature of an IP license are consistent with the proposed ASU.

Determining the Nature of an Intellectual Property License

The revenue recognition standard provides implementation guidance on whether revenue related to a distinct IP license is recognized over time or at a point in time.[3] A license that provides a right to access the entity's IP as it exists throughout the license period is an over-time performance obligation. A license that provides a right to use the entity's IP as it exists when the license is granted to the customer is a point-in-time performance obligation.

The Board tentatively agreed to amend the implementation guidance on IP licenses to require an entity to classify IP into one of two categories.

- ***Functional IP.*** IP is functional if the customer derives a substantial portion of the overall benefit from the IP's stand-alone functionality. Functional IP would generally include software, biological compounds, drug formulas, and completed media content (e.g., films, television shows, and music). Consideration for functional IP would generally be recognized as revenue at the point in time when control of the IP transfers to the customer. However, if the functionality of the IP is expected to substantively change during the license period as a result of activities of the entity, and the customer is contractually or practically required to use the updated IP, then the consideration would be recognized as revenue over time.
- ***Symbolic IP.*** IP is symbolic if it does not have significant stand-alone functionality, and substantially all of the customer's benefit is derived from its association with the licensor's ongoing activities. Symbolic IP would generally include brands, trade names such as sports team logos, and franchise rights. Consideration for symbolic IP would generally be recognized as revenue over the license period using a measure of progress that reflects the licensor's pattern of performance.

KPMG Observations

Some comment letter respondents suggested eliminating the guidance on over-time recognition of revenue for functional IP. The Board decided to retain the guidance because the customer may not obtain substantially all of the remaining economic benefits of the IP at the beginning of the license term. The Board's decision will require an entity to first decide whether the licensed IP is functional or symbolic. If the IP is functional, an entity will then need to apply additional criteria to determine whether revenue related to functional IP is recognized over time. Although over-time revenue recognition for functional IP is not expected to occur frequently, application of the guidance will require judgment.

[3] FASB ASC paragraphs 606-10-55-59 to 55-64, available at www.fasb.org.

Other respondents pointed out that symbolic IP does not always involve ongoing activities to support the IP. In those cases, the customer is able to obtain substantially all of the remaining economic benefits of the IP at the beginning of the license term. Although the Board considered adding an exception to the guidance on symbolic IP, it decided not to do so because of concerns about complexity. Consequently, all symbolic IP would result in over-time revenue recognition.

Applying the Sales- and Usage-based Royalties Exception

The Board's clarifications to the royalties exception are consistent with the proposed ASU. The Board did not define predominant and did not expand the exception to sales or in-substance sales of IP.

The revenue recognition standard includes an exception to the guidance on estimating variable consideration for sales- and usage-based royalties on IP licenses. The standard prohibits an entity from estimating these forms of variable consideration. Instead, it specifies that an entity can only recognize revenue for a sales- or usage-based royalty for an IP license at the later of (a) when the subsequent sale or usage occurs, or (b) the performance obligation has been satisfied or partially satisfied. The FASB discussed the fact that the *later of* guidance was intended to ensure that revenue is not recognized prior to the satisfaction of the performance obligation.

When an IP license includes other goods or services, the Board agreed to clarify that an entity either applies, in its entirety, the royalties exception or the general guidance on variable consideration (including the constraint). The royalties exception must be applied when the royalty is given in exchange for a distinct IP license or when the IP license is the *predominant* item to which the royalty relates. The FASB has not proposed providing guidance on the definition of predominant, but has acknowledged that determining when a license is the predominant item may require significant judgment. For arrangements that contain both an IP license and other non-IP goods or services, this determination may give rise to significant judgments about the amount of the transaction price and timing for the recognition of variable consideration that relates to a sales- or usage-based royalty.

The Board discussed expanding the scope of the royalties exception to sales of intellectual property. However, the Board decided not to expand the royalties exception beyond the guidance discussed above. The Board decided that the royalties exception should apply to all licenses, even if in-substance it is a sale (e.g., a worldwide, perpetual, or exclusive license). The legal form of the arrangement will be the driving factor to determine whether the royalties exception applies.

Other Clarifications on Licenses

When to Determine the Nature of an Intellectual Property License

The Board reaffirmed its previous tentative decision that when an IP license is not distinct from other goods or services in a contract, it may be necessary to determine the nature of the license to determine whether the performance obligation (a bundle of goods or services including the license) is satisfied over time or at a point in time. For example, if a license is bundled with goods or services that are provided over a period shorter than the license term, an entity may need to consider the nature and term of the license when determining the pattern for revenue recognition of the bundled arrangement.

The Board's clarifications on when to determine the nature of an IP license are consistent with the proposed ASU.

KPMG Observations

The Board's tentative decision on when to apply the licensing guidance for a bundled performance obligation is based on the notion that an entity is always supposed to consider the nature of its promise when determining an appropriate method for measuring progress. The amendment clarifies the original revenue standard, which specified that the licensing guidance only applies to distinct licenses of intellectual property. The Basis for Conclusions in the original revenue standard, however, noted that in some cases the combined good or service may have a license as its primary or dominant component. Some believed that it is appropriate to apply the licensing guidance to bundled arrangements only when the license is the primary or dominant good or service in the contract. The amendments would make the licensing guidance for determining whether to recognize revenue at a point in time or over time more broadly applicable to arrangements where the license is not the primary or dominant good or service. An entity would not have to apply the licensing guidance to every performance obligation that includes IP. Rather, an entity would consider whether the licensing guidance is necessary to understand the nature of the entity's promise and the period over which the performance obligation is satisfied.

In addition, the guidance is different than the guidance on sales- or usage-based royalties, which is expected to be amended to specify that the royalties exception applies to bundled arrangements only if the royalty predominantly relates to an IP license.

The Board's clarifications to contractual restrictions are consistent with the proposed ASU.

Contractual Restrictions

The Board also tentatively agreed to clarify that contractual restrictions on time, geography, or a licensee's ability to use or access the underlying IP are attributes of the license and do not impact the number of performance obligations in the contract. These restrictions define the scope of the license rather than the number of distinct licenses in the arrangement. For example, a license that allows a television station to broadcast a movie on four specific dates during the license term would generally be a single performance obligation. However, some contractual restrictions are not restrictions on the licensee's ability to use or access the IP. For example, if the licensee has the right to use or access the IP for two distinct periods of time, the period between the license periods is substantive, and the licensor has the ability to grant the right to use or access the IP to another party during that intervening period, then the contract would include more than one performance obligation.

KPMG Observations

The Board acknowledged that there have been a number of questions raised about applying the guidance on contractual restrictions. Specifically, the questions have centered around which contractual restrictions are attributes of the license and which restrictions give rise to separate performance obligations. The Board decided that it would move forward with the amendments in the proposed ASU. However, it plans to discuss those amendments with the Transition Resource Group for Revenue Recognition (TRG) at the next TRG meeting on November 9, 2015. If the TRG members have significant concerns with the operability of the proposed guidance, then perhaps the Board would consider making further changes to this guidance. However, the Board plans to proceed with the other amendments and clarification even if further changes on contractual restrictions are deemed necessary.

The Board's clarifications to identifying promised goods or services are consistent with the proposed ASU. However, the Board will also provide cost guidance for services that are immaterial in the context of the contract.

Identifying Promised Goods or Services

The first step in identifying performance obligations is to identify the goods or services promised in the contract. The standard states that promised goods or services are not limited to the goods or services that are explicitly stated in the contract. Rather, the contract may include promises that are implied by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a valid expectation of the customer that the entity will transfer goods or services to the customer. However, administrative tasks an entity must undertake to fulfill a contract that do not transfer goods or services to the customer are not performance obligations.[4]

[4] FASB ASC paragraphs 606-10-25-16 to 25-17, available at www.fasb.org.

The Board tentatively agreed to amend the standard to specify that an entity is not required to identify as a performance obligation those goods or services to be transferred to the customer that are immaterial in the context of the contract. This guidance was provided in an attempt to make implementation of the revenue standard less costly for some preparers.

The Board emphasized that immaterial in the context of the contract is a qualitative and quantitative assessment based on what may be important to the customer. This is a different concept than materiality that is applied to the financial statements as a whole, which focuses on information that is important to financial statement users.

KPMG Observations

Several comment letter respondents indicated that the term immaterial could lead to complexity when applying the guidance because it would introduce a new materiality concept. It is as yet unclear to what degree immaterial in the context of the contract includes other quantitatively small-dollar items that would not have been considered inconsequential or perfunctory, a commonly understood concept within legacy U.S. GAAP.[5]

The Board decided to provide guidance that will require costs associated with promises deemed to be immaterial in the context of the contract to be accrued when the goods or services are provided to the customer.

Distinct in the Context of the Contract

The Board's clarifications to distinct in the context of the contract are consistent with the proposed ASU.

The process of identifying performance obligations requires an entity to determine which goods and services are distinct. A good or service is distinct if the customer can benefit from it on its own or with other resources that are readily available to the customer *(capable of being distinct)* and the promise to transfer the good or service is separately identifiable *(distinct in the context of the contract)*. While the first criterion is similar to the stand-alone value notion that exists in current U.S. GAAP, the second criterion is new.[6]

The Board tentatively agreed to amend the guidance on distinct in the context of the contract, consistent with the proposed ASU.

- Explanatory language will be provided to better articulate the principle. The revised language will indicate that the objective when considering whether promised goods or services are separately identifiable is to determine whether the nature of the entity's overall promise in the contract is to transfer (a) each of those separate goods or services, or (b) a combined item (or items) to which the promised goods or services are inputs.

[5] SEC Staff Accounting Bulletin Topic 13.A.3.c, available at www.sec.gov.

[6] FASB ASC paragraph 605-25-25-5(a), available at www.fasb.org.

- The factors for determining what is distinct in the context of the contract will be revised to more closely relate to the separately identifiable principle. In addition, the factors will refer to the goods and services in the contract as a bundle to focus the analysis on when goods or services significantly affect each other.
- Examples will be added to demonstrate how the separation guidance should be applied.

KPMG Observations

In general, the rearticulated principle, related indicators, and additional examples represent an improvement to the revenue recognition standard. These changes should be helpful to stakeholders in determining whether goods or services are distinct within the context of the contract.

Series Guidance

The revenue standard requires that if promised goods or services are (1) distinct; (2) substantially the same; (3) transferred to the customer over time; and (4) the same measure of progress would be used for each individual good or service, then the aggregate promised goods or services in the contract *must* be accounted for as a single performance obligation (the series guidance).[7]

Applying the series guidance impacts the accounting related to the allocation of variable consideration, contract modifications, and changes in the transaction price. Some had previously informed the FASB that this guidance was overly complex for some arrangements.[8] In the proposed ASU, the Board asked constituents whether they believe the series guidance should be optional.

Although some respondents favored making the series guidance optional, others indicated this would result in lack of comparability. Additionally, the IASB is not currently considering making its series guidance optional. The Board decided that it would *not* make the series guidance optional. That is, if the criteria for applying the series guidance are met, an entity must treat the series as a single performance obligation. The Board also instructed the FASB staff to ensure appropriate education was provided for the series guidance because the Board believes that many of the questions arose because of a lack of understanding.

The revenue standard also requires that an entity disclose the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied or partially satisfied at the end of the reporting period and provide an explanation about when the entity expects to recognize this amount as revenue.[9] The Board considered whether to exempt entities that are subject to the series guidance from this disclosure requirement. The Board determined that further analysis was needed before it could conclude that changes in the disclosure requirements are appropriate.

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[7] FASB ASC paragraph 606-10-25-14b, available at www.fasb.org.

[8] See KPMG Defining Issues No. 15-13, Revenue Transition Group Discusses Consideration Payable to a Customer, Series Guidance, available at www.kpmg-institutes.com.

[9] FASB ASC paragraph 606-10-50-13, available at www.fasb.org.

KPMG Observations

Although entities *must* apply the series guidance if certain criteria are met, the Board is aware of the difficulties associated with disclosing the amount allocated to unsatisfied performance obligations when an entity's performance obligation is a series and the variable consideration is allocated entirely to each distinct good or service.

However, the Board decided not to provide an exemption from the disclosure requirements until it obtains a more comprehensive understanding of preparers' concerns and potentially about other disclosure requirements in the standard. The Board emphasized that it is not interested in reopening a broad discussion on the disclosure requirements of the revenue standard. However, it is aware that many companies are just beginning to develop an understanding of the standard's disclosure requirements. Entities should consider sharing other concerns about disclosures either formally or informally with the Board because it may consider making some limited exemptions.

Accounting for Shipping and Handling Services

The Board's clarifications to shipping and handling are consistent with the proposed ASU. However, the Board will also provide cost guidance for shipping and handling.

An entity may bill a customer for shipping and handling services in addition to the stated price of the goods or services. Unlike current U.S. GAAP, the revenue recognition standard does not provide specific guidance for the presentation of shipping and handling fees when an entity charges separately for them.[10] However, it defines the transaction price as the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, which generally would include amounts charged for shipping and handling.

The more significant question is whether the entity is required to identify shipping and handling services as a performance obligation (whether or not it charges the customer for these services) when it concludes that it has transferred control of the goods to the customer before the product is shipped. The Board tentatively concluded that it will provide a policy election that would allow an entity to choose to account for shipping and handling either as a fulfillment cost or as a promised service when transfer of control of the goods occurs before the goods are shipped. The Board decided to provide guidance requiring costs associated with shipping and handling activities to be accrued when control of the related goods has transferred to the customer and the entity has determined that it will not account for shipping and handling as a separate performance obligation.

[10] FASB ASC paragraphs 605-45-45-19 to 45-21, available at www.fasb.org.

Example: Shipping and Handling Services

An entity sells a product to a customer and ships the product with FOB shipping point terms. The entity has a customary business practice of replacing products if they are damaged in transit (synthetic FOB destination). The entity must determine whether control transfers at the shipping point or if control does not transfer until it arrives at the customer's location. If the entity concludes that control of the goods transfers at the shipping point, the entity could treat the shipping as a separate performance obligation. This would result in recognizing revenue allocated to the goods when they are shipped, and revenue allocated to the shipping performance obligation would be recognized as shipping occurs.

Alternatively, the entity could elect to treat the shipping as a fulfillment cost. This would result in all of the revenue being recognized when the goods are shipped and accruing the cost of shipping.

If the entity concludes that control of the goods transfers when the goods arrive at the customer's location, then the entity would treat the shipping as a fulfillment cost, and recognize all of the revenue when the goods are delivered to the customer's location.

The FASB noted that the cost of shipping and handling that occurs *prior* to the customer obtaining control of the goods is a fulfillment cost rather than a performance obligation.

KPMG Observations

Under current U.S. GAAP entities may have arrangements with FOB shipping point terms that are accounted for as FOB destination arrangements (i.e., synthetic FOB destination) because the entity has determined that risks and rewards do not pass to the customer at shipping point (e.g., the entity has a business practice of covering damage to the product that occurs in the shipping process or providing the customer with a replacement product if the product is lost in transit). All entities will need to consider the indicators included in the revenue standard to determine when control transfers, which may require significant judgment and may lead to diversity in practice. In particular, entities that currently recognize revenue when the goods arrive at the customer location based on synthetic FOB destination terms may determine that under the revenue standard control transfers to the customer when the goods are shipped and will need to make a policy election to account for the shipping services as a fulfillment activity or a performance obligation. The IASB is not proposing a similar amendment. Consequently, this could be an area that results in divergent outcomes.

Next Steps

The FASB intends to issue an Accounting Standards Update covering these topics before the end of 2015.

The FASB recently issued an exposure draft on other narrow-scope improvements and practical expedients with comments due by November 16, 2015.[11] In addition, the FASB previously issued an exposure draft to amend the guidance on determining whether the entity is a principal or an agent with comments due by October 15, 2015.[12]

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

Contributing authors: Brian K. Allen, Meredith Canady, Prabhakar Kalavacherla, Paul H. Munter, Brian J. Schilb, Maricela Frausto, and Jonathan M. Hunt

Earlier editions are available at: http://www.kpmg-institutes.com

[11] FASB Proposed Accounting Standards Update, Narrow-Scope Improvements and Practical Expedients, September 30, 2015, available at www.fasb.org.

[12] FASB Proposed Accounting Standards Update, Principal versus Agent Considerations (Reporting Revenue Gross versus Net), August 31, 2015, available at www.fasb.org.

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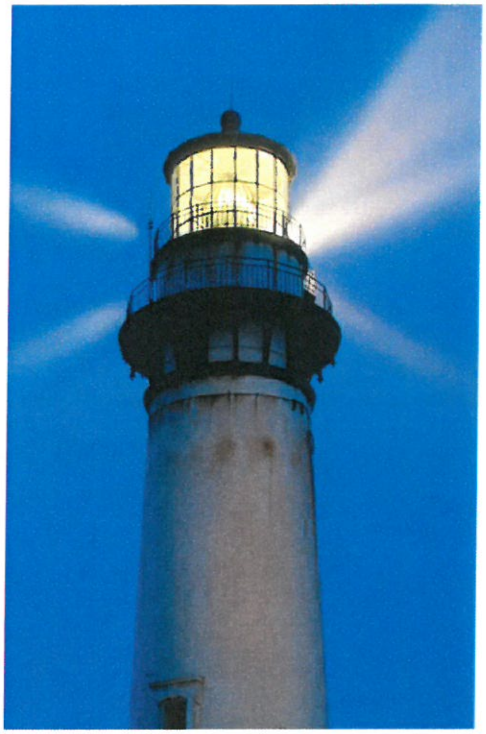
November 2015, No. 15-50



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FASB Sets 2019 Effective Date for New Leases Standard

At its November 11 meeting, the FASB set the effective dates of the new leases standard and decided to permit early adoption. The FASB also discussed cost-benefit considerations and a follow-up issue related to lease classification to complete its due process. The FASB plans to issue a final leases standard in January 2016.

Key Facts

- Public business entities, certain not-for-profit entities, and certain employee benefit plans will be required to apply the new leases standard for interim and annual periods in fiscal years beginning after December 15, 2018.
- All other entities will be required to apply the new leases standard for fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning one year later.
- Early adoption will be permitted for all entities.
- Entities will not apply the lease-term criterion when evaluating classification of a lease that begins near the end of an asset's economic life.[1]

Key Impacts

- Issuance of the new leases standard is just around the corner. Entities should start assessing how it will affect them if they haven't already done so.
- Entities can elect to early adopt the leases standard beginning in 2016.
- Determining whether an asset is *near the end* of its economic life will involve judgment. Using the 25 percent threshold currently in U.S. GAAP to make that judgment will be considered a *reasonable approach*.[2]
- When the lease term begins near the end of an asset's economic life, entities will apply the other lease-classification criteria to determine whether the lessee obtains control of the underlying asset.

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[1] The lease-term criterion: Is the lease term for the major part of the underlying asset's remaining economic life?

[2] ASC Topic 840, Leases, available at www.fasb.org.

Adoption Date Considerations

The FASB decided not to align the effective date of the new leases standard with the revenue standard. Early adoption will allow entities to adopt the leases standard *before* the revenue standard.

Except for early adoption, the FASB's decision on effective date for public business entities aligns with the IASB's recent decision for its leases standard.[3]

Because the leases standard can be early adopted on issuance, entities could decide to adopt it before they adopt the new revenue standard.[4]

KPMG Observations

The alignment of the effective dates for the FASB's and IASB's leases standards will make it easier for global entities to prepare their financial statements.

Given the interplay between the new leases and revenue standards, entities should consider their facts and circumstances and potential benefits of adopting the leases and revenue standards concurrently. Implementation challenges may arise when entities adopt the leases standard at the effective date. For example, current U.S. GAAP lease accounting guidance contains specific real estate sale-leaseback accounting guidance that was not carried forward to the new leases and revenue standards.

Lease Classification Issue

Current U.S. GAAP and the forthcoming leases standard include similar lease classification tests, including a lease-term criterion. However, current U.S. GAAP is more prescriptive than the leases standard will be.

The FASB received feedback that current operating leases with lease terms beginning near the end of an asset's economic life may be classified as finance leases under the proposed guidance solely based on the asset's age. Under current U.S. GAAP, when the lease term falls within the last 25 percent of an asset's total estimated economic life, the lease-term criterion is not applied.

The FASB decided to include a similar exception in the new standard without requiring the use of the bright line. While determining whether an asset is near the end of its economic life will require judgment, entities may apply the 25 percent threshold in current U.S. GAAP as a *reasonable approach* to make that judgment.

KPMG Observations

Interestingly, no concerns were raised about the fair value lease-classification criterion, although a similar exception exists for end-of-life leases when applying that criterion under current U.S. GAAP.

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[3] IFRS 16, Leases, available at www.ifrs.org.

[4] ASC Topic 606, Revenue from Contracts with Customers, available at www.fasb.org.

Under the forthcoming standard, lease classification will be based on whether the lease gives the lessee control of the underlying asset. One criterion indicating control transfer is when the asset is so specialized that it is expected to have no alternative use to the lessor at lease expiration. With the FASB's decision, lease classification will now potentially be different from current guidance based solely on an asset's uniqueness.

Because this issue is specific to U.S. GAAP, it will create an additional difference with IFRS 16.

Cost-Benefit Considerations

The FASB concluded that the benefits of the new leases standard will outweigh implementation costs, and that financial statement users will receive better information under the new standard.

- For lessees, all leases (except short-term leases) will be recognized on balance sheet, which will improve comparability between entities and reduce differences related to how financial statement users adjust the financial reporting for leases.
- More information will be disclosed in the financial statement notes for both lessees and lessors to provide a more complete picture of their leasing activities and exposure (e.g., asset risk and, for lessors, credit risk).

The FASB believes implementation and ongoing compliance costs with the new standard will not be as significant as they would have been under the 2010 and 2013 exposure drafts. Through redeliberations, the FASB made decisions it believes will reduce the necessary changes to systems and processes for both lessees and lessors.

Staying Informed

The FASB expects to issue an Accounting Standards Update in January 2016. KPMG will issue a *Defining Issues®* about the new standard when it is issued followed by an *Issues In-Depth* with a more comprehensive analysis of the new standard.

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

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Earlier editions are available at: http://www.kpmg-institutes.com

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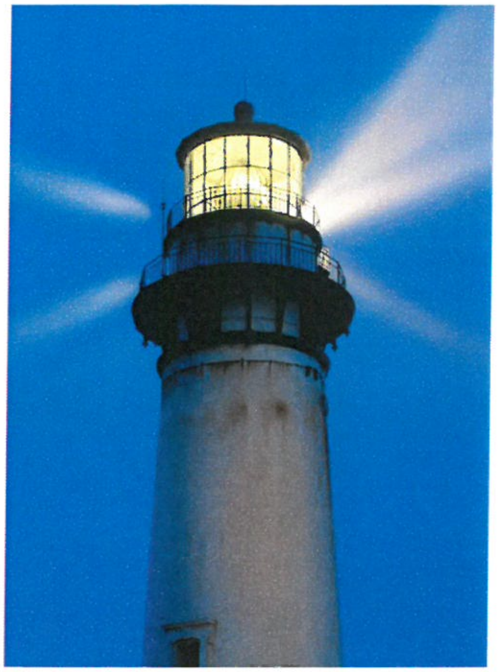
July 2015, No. 15-31



Revenue Transition Resource Group Discusses Nine Issues

The Joint Transition Resource Group for Revenue Recognition (TRG) met for the fifth time on July 13, 2015, and discussed nine issues related to the joint FASB/IASB revenue recognition standard.[1] This edition of *Defining Issues* summarizes the key points discussed at the meeting.

Key Facts

- Fees charged by credit-card issuing banks to cardholders are generally outside the scope of the revenue standard under U.S. GAAP. Because IFRS does not have explicit guidance on the accounting for credit card fees, differences between IFRS and U.S. GAAP could arise.
- Depending upon the facts and circumstances of an arrangement, the standard's guidance related to allocating variable consideration to the distinct goods or services that constitute a series may be applied to many service contracts as a practical accommodation.
- Consideration payable to a customer that is a reduction of revenue generally will be accounted for as variable consideration. The guidance on the timing of the recognition of consideration payable to a customer would only apply in the limited circumstance that an entity does not have the intention or an established practice of providing a payment to its customers at contract inception.
- TRG members had differing views on how to define a completed contract when applying the transition guidance.[2] This will be discussed again at the next TRG meeting.

Key Impacts

- Applying the series guidance could simplify application of the revenue model for some IT outsourcers, transaction processors, and other long-term service providers.
- TRG members generally agreed with the FASB and IASB staff's views on most of the issues, which likely means that the Boards will not undertake standard setting on those issues.

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[1] Transition Resource Group papers are available at www.fasb.org and www.ifrs.org. FASB Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers, and IFRS 15, Revenue from Contracts with Customers.

[2] FASB ASC paragraph 606-10-65-1(c)(2), available at www.fasb.org, and IFRS.C2(b).

Consideration Payable to a Customer

This topic has been discussed at two previous meetings including the March 31, 2015, TRG meeting. However, technology issues prevented the U.S. and international TRG members from holding a joint discussion.

The standard states that consideration payable to a customer includes amounts that an entity pays, or expects to pay, to a customer or to other parties that purchase the entity's goods or services from the customer. An entity should treat consideration payable to a customer as a reduction of the transaction price, unless the payment is in exchange for a distinct good or service, and the entity can reasonably estimate the fair value of the good or service. The guidance on consideration payable to a customer states that it is recognized at the *later of* when the entity recognizes revenue or when the entity pays or promises to pay the consideration (later of guidance). However, because consideration payable to a customer can be included in the transaction price, it also can be a form of variable consideration.

Because the timing of recognition would differ if it is deemed to be variable consideration versus using the later of guidance, stakeholders have asked when the guidance on consideration payable to a customer and variable consideration should be applied.

Example 1: Variable Consideration versus Consideration Payable to a Customer

Manufacturer A sells its product to Distributor A for $100 on December 1 and recognizes revenue at that time. Manufacturer A has a history of offering a $25 cash-back rebate to end-consumers in the following February.

Under the variable consideration guidance, Manufacturer A would reflect the $25 rebate in its transaction price on December 1 based on its previous business practice and intent to continue to offer this incentive. Under the later of guidance, the transaction price would be reduced in February when Manufacturer A pays the rebate to the end consumer.

In the March meeting, TRG members had differing views on whether payments made to customers should be evaluated at the contract level or more broadly at the customer-relationship level. U.S. members noted that evaluating payments broadly at the customer-relationship level is consistent with current U.S. GAAP.[3] However, many believe that the new standard was not written in that way. Most TRG members indicated that something between the broad customer-relationship view and narrow customer contract level was appropriate.

In the July meeting, both U.S. and international TRG members observed that a reasonable application of either view should result in similar financial reporting outcomes. Members also had differing views about how broadly payments within the distribution chain should be evaluated. Some members stated that customers are only those parties that are within the direct distribution chain.

[3] FASB ASC Section 605-50-25, available at www.fasb.org.

Others thought a broader view of a customer's customer should be used, citing the reference in the Basis for Conclusions to situations where an entity is acting as a marketing agent.[4] These marketing companies view the principal as their customer, but they also may view the principal's end customer (i.e., customer's customer) as their customer and therefore believe this guidance should be applied to them.

TRG members generally agreed that an entity's customer might include a customer's customer that extends beyond the direct distribution chain, and that sometimes an entity may have more than one customer. As a consequence, judgment will be needed to evaluate a specific fact pattern to determine whether a payment is treated as a reduction of revenue.

Variable consideration is estimated and included in the transaction price at contract inception and at each subsequent financial reporting date, differing from the recognition timing under the later of guidance. TRG members generally agreed that the guidance can be reconciled because not all consideration payable to a customer is variable consideration. However, this discrepancy puts pressure on determining, at contract inception, whether the entity intends to provide an incentive. This evaluation will include an assessment of the entity's past practices and other activities that could give rise to an expectation at contract inception that the transaction price is variable. The later of guidance would only be used when the entity does not have this history and has no expectation of providing incentives, which the TRG expects will occur only in limited circumstances when an entity has not implicitly (including through its customary business practices) or explicitly promised a payment to the customer at contract inception.

Credit Card Fees and Loyalty Programs

The revenue standard excludes from its scope other contractual rights and obligations that are within the scope of certain ASC Topics, including receivables. Current U.S. GAAP includes guidance on accounting for credit-card fees as part of the receivables guidance.[5] Because credit card fees may entitle the cardholder to other services (e.g., airport lounge access or roadside assistance), some have questioned whether all services embedded within the credit-card fee arrangement are within the scope of the receivables guidance or whether some of those services should be separated from the credit card fee and included in the scope of the revenue standard.

Current U.S. GAAP states that credit card fees can cover many cardholder services.[6] To the extent a fee compensates the entity for a service provided during the loan commitment period, the separate components of a commitment fee are not identifiable and reliably measurable to allow for separate accounting recognition for each component part.[7]

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[4] ASU No. 2014-09, Revenue from Contracts with Customers, paragraphs BC92 and BC255, available at www.fasb.org.

[5] FASB ASC Subtopic 310-20, Receivables—Nonrefundable Fees and Other Costs, available at www.fasb.org.

[6] FASB ASC paragraphs, 310-20-05-03 and 25-15, available at www.fasb.org.

[7] FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, paragraph BC48, available at www.fasb.org.

Instructions for submitting an issue to the TRG can be found on the FASB's Web site.

The next TRG meeting is scheduled for November 9, 2015.

The FASB staff's outreach showed that under current practice credit card fees are accounted for using the receivables guidance. In addition, constituents noted that the revenue standard scopes out transactions that are within the scope of the receivables guidance and pointed out that the revenue standard did not change the scope of the receivables guidance. Therefore, they believe that credit card fees continue to be within the scope of the receivables guidance and outside of the revenue standard's scope. While the FASB staff generally agreed with that view, it also noted that a credit card issuing bank should not assume that all of its arrangements are outside the scope of the revenue standard. In particular, the FASB staff was concerned about potential arrangements being labelled as credit-card lending arrangements, when the substance is clearly the sale of other goods or services. The TRG members generally agreed with the FASB staff's analysis.

Questions have also arisen about whether loyalty programs included in credit card arrangements are within the scope of the revenue standard. Similar to the analysis above, the determination is based on whether the credit card fee that gives the right to participate in the loyalty program falls within scope of the receivables guidance or the revenue standard. Therefore, the card-issuing bank should evaluate its specific facts and circumstances.

Under IFRS, arrangements within the scope of the financial instruments standard are scoped out of the revenue standard.[8] Because IFRS does not have explicit guidance on the accounting for credit card fees, TRG members noted that differences between IFRS and U.S. GAAP could arise.

Series Provision and Allocation of Variable Consideration

At contract inception an entity is required to account for each good or service or bundle of goods or services as a performance obligation if (a) they are distinct, or (b) they are a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer (the series provision). The series provision was included in the standard to simplify the accounting for repetitive services and to promote consistency in identifying performance obligations.[9]

In a contract to provide a repetitive service, such as a monthly cleaning service, an entity would treat the promise to provide cleaning services as a single performance obligation rather than treating each increment of service (e.g., year, month, day, or hour) as a performance obligation. Based on previous TRG discussions, the FASB included a question in its recent exposure draft about whether the series guidance should be optional.[10]

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[8] IFRS 9, Financial Instruments.

[9] ASU 2014-09, BC113, available at www.fasb.org, and IFRS 15.BC113.

[10] FASB Proposed Accounting Standards Update, Identifying Performance Obligations and Licensing, available at www.fasb.org.

Consideration of Whether Goods or Services Are Distinct and Substantially the Same

Stakeholders have questioned how to determine when more than one good or service is considered substantially the same. More specifically, the question is whether *all* of the tasks in each increment of service need to be substantially the same.

The FASB and IASB staff noted that an entity must first determine whether its promise is to provide goods or services or to stand ready to provide goods or services when requested by the customer.[11] If the nature of the promise is the delivery of a specified quantity of a service, the evaluation should consider whether each service is distinct and substantially the same. If the promise is to stand ready or to provide a single service for a period of time (i.e., there is not a specified quantity to be delivered), the evaluation would likely focus on whether each time increment, rather than the underlying activities, is distinct and substantially the same.

An entity also should consider which of the three criteria for concluding that a performance obligation is satisfied over time is met.[12] If a performance obligation is satisfied over time because the customer simultaneously receives and consumes the benefits of the services as the entity performs, that may indicate that each increment of service is capable of being distinct. If a promise is satisfied over time based on either of the other criteria, the nature of that promise could be for a single specified good or service and would not generally represent a series (e.g., a promise to provide a piece of equipment or a professional opinion).

TRG members generally agreed with the staff that a promise to perform an unspecified quantity of services for a fixed price represents an obligation to stand ready to perform the underlying services. Given the nature of the entity's promise to stand ready to perform, each day of service may be distinct because the customer can benefit from each one on its own and each day of service is separately identifiable. Even if the individual activities vary from day to day, the nature of the overall promise (e.g., hotel management services) is substantially the same. However, an entity will need to carefully evaluate specific facts and circumstances when its stand-ready obligation involves goods or services that are occasionally or sporadically provided and that do not align with the manner in which variable consideration is contractually determined.

Evaluating Whether Consideration Is Variable

TRG members agreed that the determination of whether an arrangement includes variable consideration depends on the evaluation of the entity's underlying promise. If the consideration to be received is based on the quantity of goods or services provided by the entity and the quantity is not specified in the arrangement, the transaction price is variable. TRG members agreed that an entity should consider all substantive contract terms, including contractual minimums, that could make all or a portion of the consideration fixed.

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[11] TRG Paper 16 for the January 25, 2015, TRG meeting, available at www.fasb.org and www.ifrs.org.

[12] FASB ASC paragraph 606-10-25-27, available at www.fasb.org, and IFRS 15.35.

Additionally, some TRG members noted that the November 9, 2015, meeting is expected to include a discussion of optional goods and services, which might also affect this analysis.

Allocation of Transaction Price

The standard requires variable consideration to be allocated to one or more distinct goods or services in a series if specified criteria are met.[13] The TRG members discussed various fact patterns and agreed that allocating variable consideration entirely to a distinct good or service may be acceptable when (1) the fee is the same over the duration of the contract; (2) the fee declines in a manner commensurate with the decline in the entity's cost to deliver the goods or services; (3) the fee is commensurate with the entity's standard pricing practices with similar customers; or (4) the fee is commensurate with the value of the goods or services delivered to the customer.

Applying the series guidance to a broader population of service contracts is not explicitly required by the standard. However, if the guidance is applied in a reasonable way when supported by the fact pattern, it will allow revenue to be recognized for amounts billed and modifications accounted for prospectively. When this approach is not appropriate for a fact pattern, the entity will need to estimate prices and quantities for services to be performed in the future and account for modifications using a cumulative catch-up approach.

Example 2: Allocation of Transaction Price

A company agrees to provide outsourced IT services to a customer for five years. Unit pricing is specified in the contract and is billed based on the quantity of each service provided during the period.

The company determines that the services are not separately identifiable and therefore has a single performance obligation. The customer simultaneously receives and consumes the benefits of the service as the company performs, which means the performance obligation is satisfied over time. The volumes of each type of service are undefined. Each day of service could be viewed as a distinct service, leading the company to conclude that it is providing a series of distinct services.

Rather than forecasting service quantities to estimate the transaction price for a single performance obligation to deliver IT outsourcing services over a five-year period, the company allocates the variable consideration associated with services provided in a day to the distinct increment of service (the day). At the end of each month, assuming the company has determined the contractual pricing is representative of the value to the customer, the company recognizes revenue based on the amount billed. Modifications to the contract are likely to be accounted for prospectively because additional services are distinct from the services in the original contract.

If the entity concluded that the contract included multiple performance obligations satisfied over time (not a series), the entity would estimate the quantities of services to be provided to estimate the transaction price. The

[13] FASB ASC paragraphs 606-10-32-39 to 32-41, available at www.fasb.org, and IFRS 15.84 to 86.

Example 2: Allocation of Transaction Price

transaction price would be allocated to the performance obligations and recognized as each of those services is provided. As actual quantities are determined, the entity would update the transaction price and allocate to the performance obligations on the same basis as at contract inception. Modifications to the contract that add services that are not distinct from the services in the original contract would be accounted for on a cumulative catch-up basis.

Practical Expedient for Measuring Progress

For performance obligations that are satisfied over time, an entity should identify the method that most faithfully depicts the pattern of transfer of control of the goods or services to the customer. This may be either an input or output method depending on the specific facts and circumstances of an arrangement. As a practical expedient, an entity may recognize revenue using the amount it has the right to invoice, if the amount directly corresponds with the value delivered by the entity to the customer.[14] In addition, an entity may use a similar practical expedient when disclosing information about its remaining performance obligations.[15]

Similar to the discussion on the application of the series guidance, some stakeholders have questioned whether the practical expedient can be applied to contracts with rates that change during the contract term (such as rates based on forward market prices, rates with a contractual minimum, or contracts with volume discounts) or contracts that contain multiple goods and services. The TRG generally agreed that in order for an entity to apply the practical expedient one of the following circumstances must exist:

- The price needs to change during the contract period in response to changes in the value of the goods or services to the customer;
- All of the goods or services in the contract qualify for the practical expedient; or
- The existence of a contractual minimum is nonsubstantive (i.e., the entity expects that amounts will be exceeded).

An entity will need to use judgment to assess whether the right to consideration from a customer corresponds directly to the value to the customer for the performance completed to date. In addition, if a contract contains an upfront fee, rebates, or volume discounts, an entity will need to use judgment to determine whether the payments or future discounts relate to a specific good or service. The significance of the amount in relation to the contract also will need to be evaluated when determining whether the right to payments corresponds to the value to the customer. The more significant these amounts are when they do not relate to the transfer of a good or service, the more difficult it will be for the entity to conclude that the practical expedient applies to its arrangement.

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[14] FASB ASC paragraph 606-10-55-18, available at www.fasb.org, and IFRS 15.B16.

[15] FASB ASC paragraph 606-10-50-14, available at www.fasb.org, and IFRS 15.121.

An entity will need to apply similar judgment to determine whether it can apply the practical expedient on the disclosure of remaining performance obligations.

Measuring Progress for Multiple Goods or Services in a Single Performance Obligation

If an entity satisfies a performance obligation over time, the standard requires it to recognize revenue by measuring its progress toward complete satisfaction of the performance obligation using a single method.[16] The objective when measuring progress is to depict an entity's performance in transferring control of goods or services to a customer.

Although stakeholders agree the guidance is clear that only one measure of progress can be used, some stakeholders have expressed concern that it could be challenging to select and apply a single method when the entity is transferring control of multiple goods or services over time that have been combined into a single performance obligation.

TRG members generally agreed that using multiple methods of measuring progress for the same performance obligation would not be appropriate. While acknowledging that selecting a single measure of progress will require significant judgment in some situations, the TRG members generally agreed that evaluating the nature of the entity's overall promise will help identify an appropriate measure of progress for the bundle of goods and services.

For example, in an arrangement where an entity promises to provide a software license (right to use intellectual property) and integration services that will customize the software to add significant new functionality, the entity likely would conclude that the software and installation services are not separately identifiable and should be combined into a single performance obligation. TRG members generally agreed that the measure of progress should be based on a method that reflects the entity's progress toward completion of the customized software solution. In other words, revenue would be recognized over the period that the integration services are performed.

In another example, assume a professional services entity provides a professional opinion to a customer, and it concludes that the arrangement meets the criteria for recognition of revenue over time (the fee is a fixed amount plus reimbursement of out-of-pocket expenses). Because a single method of revenue recognition is required, the entity may need to estimate the total consideration, including the reimbursement of out-of-pocket expenses, and then use a single attribution method such as direct labor hours for recognizing the estimated revenue over the period that the professional services are provided.

TRG members emphasized that difficulties in identifying a single measure of progress may mean that the entity needs to revisit its assessment of whether the goods or services are distinct.

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[16] FASB ASC paragraph 606-10-25-32, available at www.fasb.org, and IFRS 15.40.

Determining When Control of a Commodity Transfers

When a commodity is not accounted for as a derivative (i.e., normal purchase normal sale exception is applied), stakeholders have questioned whether control of the commodity transfers to a customer over time or at a point in time. Specifically, when evaluating whether a customer simultaneously receives and consumes the benefits of a commodity as the seller produces the commodity, some believe the seller should evaluate only the inherent characteristics of the commodity. Others believe the seller should also consider other factors including the contract terms, infrastructure of the parties, and other delivery mechanisms.

For example, considering other factors beyond the inherent characteristics of the commodity might lead a gas producer to conclude that its performance obligation is satisfied over time if the gas is continuously fed into a customer's power plant and immediately consumed.

Conversely, the gas producer would conclude that its performance obligation is satisfied at a point in time if the gas is transferred into a storage facility. This is important because distinct goods or services that are substantially the same and that transfer over time are a series. This may allow companies to recognize the amounts billed as revenue. Distinct goods or services that transfer at a point in time are not eligible for the series guidance. These contracts require the entity to estimate the prices and quantities when determining the transaction price and to allocate the transaction price to the performance obligations perhaps based on the projected quantities to be delivered.

TRG members generally agreed with the staff that the entity should consider all relevant facts and circumstances when evaluating whether the promise to deliver a commodity is transferred over time or at a point in time. They emphasized that evaluating the overall nature of the promise will assist the entity in assessing whether the performance obligation is satisfied over time or at a point in time. The staff agreed to include in the minutes of the meeting examples to illustrate the different outcomes. It is possible that this issue may be reconsidered after additional examples are developed and significant differences in accounting outcomes are identified.

Accounting for Restocking Fees and Related Costs

An entity sometimes charges a customer a restocking fee when a product is returned. The restocking fee is intended to compensate the entity for costs associated with a product return or the reduced selling price an entity may charge when re-selling the product to another customer. TRG members agreed that restocking fees for products expected to be returned should be included as part of the estimated transaction price when control transfers. They said a returned product subject to a restocking fee is similar to a partial return right (i.e., the customer receives a partial refund).

TRG members agreed that the costs related to restocking should be reflected when control of the product transfers as a reduction in the carrying amount of the asset expected to be recovered. This is consistent with the guidance that specifies that any expected costs to recover returned products should be included by reducing the carrying amount of the asset recorded for the right to recover those products.[17]

Practical Expedient for Portfolio of Contracts

The revenue standard includes a practical expedient that allows an entity to account for a portfolio of contracts with similar characteristics as a single unit if the entity reasonably expects that the financial reporting impact would not be materially different from applying the standard to each individual contract. The standard also requires an entity to estimate variable consideration using either the expected value method or the most likely amount when determining the transaction price. The entity's estimate of variable consideration is further constrained to the extent that it is probable (highly probable under IFRS) that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved.

Stakeholders have questioned whether an entity is using the portfolio method when it considers evidence from similar contracts to develop an estimate using the expected value method. TRG members generally agreed that estimates using the expected value method are made at the contract level, not at the portfolio level. These estimates generally are developed using a portfolio of data when the entity has a sufficiently large number of similar transactions or other history, and that doing so is not using the portfolio practical expedient.

Because of this confusion, some stakeholders have also questioned whether the estimated transaction price under the expected value method can be an amount that is not a possible outcome of an individual contract. For example, an entity enters into contracts with similar terms with a large number of customers. The terms of the contract include a performance bonus related to the timing of completing the contract. Based on historical experience, the bonus amounts and the probabilities of achieving the bonus follow.

Bonus Amount	Probability of Occurrence
$0	15%
$50	40%
$100	45%

[17] FASB ASC paragraph 606-10-55-27, available at www.fasb.org, and IFRS 15.B25.

The estimated transaction price using an expected value method is $65 ([$0 x 15%] + [$50 x 40%] + [$100 x 45%]). The entity further concludes that the constraint does not apply because the entity is sufficiently confident in its estimate. Some believe that the transaction price is $65 because that is the estimate using the expected value method. The contract includes three possible outcomes of which $50 is the probable amount that can be achieved when viewed at a contract level (85 percent likely to achieve at least $50). Therefore, some believe the transaction price is $50 because the outcome could not be $65.

The TRG members generally agreed that when an entity has a sufficient population of similar transactions and uses this data to estimate the transaction price using the expected value method, the transaction price may be an amount that is not a possible outcome for an individual contract. TRG members emphasized that an entity would need to have a sufficiently large number of similar transactions to conclude that the expected value method is the best estimate of the transaction price.

An entity may need to use judgment to determine whether:

- Its contracts with customers are sufficiently similar;
- Contracts from customers in which the expected value is derived are expected to remain consistent with subsequent contracts; and
- The volume of similar contracts is sufficient to develop an expected value.

Completed Contracts at Transition

An entity that applies the modified retrospective approach when adopting the standard will apply it to contracts that are not completed as of the initial application date.

The transition guidance states that a contract is considered completed if the entity has transferred all of the goods and services identified under current U.S. GAAP/IFRS. The concept of transferring control of all goods and services is a new concept in the standard that differs from recognition concepts and rules embedded in legacy U.S. GAAP. This difference in underlying principles may create transition difficulties.

The TRG discussed whether an entity should define a completed contract as a contract in which the goods and services have been delivered, or a contract in which all revenue has been recognized under legacy U.S. GAAP. For contracts considered completed at the initial date of adoption, TRG members discussed whether it is permissible for an entity to recognize revenue based on legacy U.S. GAAP after the effective date of the revenue standard because doing so would result in mixed-GAAP. U.S. TRG members generally agreed that a mixed-GAAP approach would not be in accordance with the standard, but that following this approach could make some revenue disappear because the subsequent settlement or collections would not be reflected as revenue under either legacy U.S. GAAP or the revenue standard.

Example 3: Completed Contracts at Transition

A publicly traded, calendar year-end company sells its products to a distributor on December 15, 2017. The company's accounting policy is to recognize revenue subsequent to the delivery of the related goods when the amounts are due and payable from the distributor. These amounts are not considered fixed or determinable at the time the goods are delivered to the distributor so the entity is on a sell-through basis for revenue recognition under current U.S. GAAP.

The company adopts the revenue standard on January 1, 2018, using the cumulative-effect method of transition. The amounts for the sale of the products are not yet due and payable to the company. The company could conclude that its contract is completed at the date of adoption because it has transferred the goods prior to adoption, even though it has not yet recognized all the revenue from that transaction. Thus, the contract would be outside the scope of the revenue standard.

It is unclear whether subsequent cash collections would be recognized as revenue under legacy U.S. GAAP, or if the cash collections would be recognized as additions to beginning retained earnings.

Some FASB members noted that further consideration of the treatment of completed contracts at transition was warranted, and they requested the FASB staff to prepare further analyses and examples.

Next Steps

The FASB and IASB are working on potential changes to their standards.

- ***Effective Date.*** At its meeting on July 9, 2015, the FASB agreed to defer the effective date of its standard for one year.[18] The IASB is expected to consider the effective date of its standard at its July 22, 2015, meeting.
- ***Principal versus Agent Guidance.*** At their joint June meeting, the FASB and IASB agreed to propose amendments to their respective standards to clarify how the principal versus agent guidance should be applied for determining whether revenue should be presented gross (as a principal) or net (as an agent).[19] Before issuing its exposure draft, the FASB will discuss how to estimate gross revenue when the principal does not have visibility into the selling price to the end customer at a future Board meeting.

[18] See Defining Issues No. 15-30, FASB Finalizes One-Year Deferral of the Revenue Standard, available at www.kpmg-institutes.com.

[19] See Defining Issues No. 15-27, FASB and IASB to Propose Amendments to Principal-Agent Guidance in Revenue Standard, available at www.kpmg-institutes.com.

- ***Licenses of Intellectual Property and Identifying Performance Obligations.*** The comment letter period related to the FASB's exposure draft for identifying performance obligations and licensing of intellectual property ended on June 30, 2015. The FASB is in the process of evaluating comment letters and is expected to begin redeliberations soon.
- ***Transition Practical Expedients, Sales Tax Presentation, Measurement of Noncash Consideration, and Collectibility.*** The FASB expects to issue its exposure draft with a 45-day comment period by August 2015.
- ***IASB Plans.*** The IASB plans to issue a single exposure draft. The IASB exposure draft will propose less extensive changes to the standard than those addressed or to be addressed in the FASB exposure drafts. The IASB expects to issue its exposure draft in July 2015.
- ***Next TRG Meeting.*** The TRG's next meeting is scheduled for November 9, 2015.

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

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Earlier editions are available at: http://www.kpmg-institutes.com

EUROPEAN PUBLIC
REAL ESTATE ASSOCIATION

13 September 2013

International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

Re: FASB File Reference No. 2013-270, *Leases (Topic 842)*, a revision of the 2010 proposed FASB Accounting Standards Update, *Leases (Topic 840)* & IASB Exposure Draft – *Leases* (ED/2013/6)

Dear Sir/Madam,

We are pleased to submit this letter on the International Accounting Standards Board's (IASB) and Financial Accounting Standards Board's (FASB) (collectively "the Boards") Exposure Draft: Leases. We are submitting these comments on behalf of the undersigned investors and property sector analysts. As major investors into property and investment property companies (including REITs) these financial statement users have a strong interest in ensuring that the reporting related to investment property is relevant and transparent.

Recognition of investment property and rental income in line with current IFRS

We are fully supportive of the conclusion reached by the Boards to allow lessors of investment property to continue to recognise the investment property on the lessor's Balance Sheet and full rental income on the lessor's Income Statement for the vast majority of leases. The proposed accounting provides decision-useful information on which to base our evaluation of the investment quality of investment properties and companies that own and operate portfolios of investment property. In addition, the proposed accounting is broadly consistent with current accounting guidance for most commercial real estate leases under both IFRS and U.S. GAAP.

As stated in our letter of November 2010, information regarding the full amount of rental income is fundamental to investors in assessing the performance and investment quality of investment property companies. That is why International Accounting Standard No 40 *Investment Property* (IAS 40) is well supported by industry financial statement preparers reporting under IFRS and industry financial statement users. It requires a property company to disclose the fair value of its property and reports full rental income in the profit and loss account.

We acknowledge the Boards' recognition of IAS 40 in the proposed guidance for accounting by lessees that control property through leasehold interests. Under the proposed accounting, companies that lease property that qualifies as investment property under IAS 40 would be accounted for as investment property. This would include the choice to report these properties at fair value.

Finally, we want to reiterate our previously expressed view that removing the visibility over the investment property, as well as the full rental income, would represent a step backward in terms of investment property companies communicating effectively the profitability and financial position of the company to investors, analysts, and other users.

The investors identified below would be pleased to meet with the Boards or staff to discuss in more detail the views of users of the financial statements of investment property companies.

If you would like to discuss this matter with us, please contact either Andrew Saunders at andrew.saunders@epra.com or George Yungmann at gyungmann@nareit.com.

We thank the FASB and IASB for the opportunity to comment on the Boards' Exposure Drafts with respect to this very important project.

Respectfully submitted,

Investment institutions

Name	**Organisation**	**Property AUM (€million)**	**E-mail**
John Robertson	RREEF	36,700	CONTACT DETAILS PROVIDED SEPARATELY
Guido Bunte	Cornerstone Real Estate Advisers	29,600	
Roger Lees	Aviva Investors	28,500	
Rafael Torres Villalba	All Pension Group (APG)	25,000	
Marc Halle	Pramerica/Prudential	23,400	
Rogier Quirijns	Cohen & Steers	22,300	
Alex Jeffrey	M&G Real Estate	19,000	
Simon Robson	CBRE Clarion Securities	17,400	
Hans Op 't Veld	PGGM Investments	15,400	
Timothy Pire	Heitman	15,300	
Patrick Sumner	Henderson Global Investors	13,000	
Theodore Bigman	Morgan Stanley Investment Management	12,100	

Investment institutions contd.

Bill Hughes	Legal & General Property	10,900	CONTACT DETAILS PROVIDED SEPARATELY
Andrew Jackson	Standard Life Investments	10,400	
Craig Mitchell	Dexus Property Group	9,400	
Saker Nusseibeh	Hermes Real Estate Inv Management	6,500	
Robert Oosterkamp	AEW Global Advisors	6,030	
Stephen Tross	Bouwinvest REIM	6,000	
James Rehlaender	European Investors, Inc	5,100	
Jan Willem Vis	BNP Paribas Investment Partners	3,000	
Jos Short	Internos Global Investors	2,000	
Mark Townsend	Asset Value Investors	1,800	
Frank Haggerty	Duff & Phelps Investment Management	1,400	
Steven Brown	American Century Investments	1,400	
Matthijs Storm	Kempen & Co	1,100	
Vincent Bruyère	Degroof Fund Management Company	250	
Charles Fitzgerald	V3 Capital Management LP	190	

Investment analysts

Name	Organisation	Email
John Lutzius, Mike Kirby	Greenstreet Advisors	CONTACT DETAILS PROVIDED SEPARATELY
Harm Meijer	JP Morgan	
Bart Gysens	Morgan Stanley	
Jan Willem van Kranenburg	ABN AMRO	
Alex Moss	Consilia Capital	
Nick Webb	Exane BNP Paribas	
Steven Sakwa	ISI Group	

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

February 15, 2012

Ms. Susan M. Cosper
Technical Director
File Reference No. 2011-220
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Proposed Accounting Standards Update—*Consolidation (Topic 810): Principal versus Agent Analysis*

Dear Ms. Cosper:

This letter is submitted in response to the request for public comment by the Financial Accounting Standards Board (FASB or the Board) with respect to its proposed Accounting Standards Updates on *Consolidation (Topic 810): Principal versus Agent Analysis* (the Proposed Update).

NAREIT is submitting these comments on behalf of the Real Estate Equity Securitization Alliance (REESA). This alliance includes the following organizations:

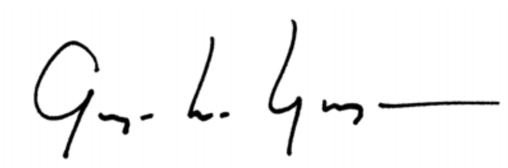
- Asia Pacific Real Estate Association, APREA
- British Property Federation, BPF
- European Public Real Estate Association, EPRA
- National Association of Real Estate Investment Trusts (United States), NAREIT
- Property Council of Australia, PCA
- Real Property Association of Canada, REALpac

The purpose and activities of REESA are discussed in Appendix I. Members of the organizations identified above would be pleased to meet with the Board or staff to discuss any questions regarding our comments on the Proposed Update.

1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 REIT.com

We thank the FASB for the opportunity to provide further input on the Consolidation proposal. If you would like to discuss our comments, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at 202-739-9432 or Christopher Drula, NAREIT's Senior Director, Financial Standards, at 202-739-9442.

Respectfully submitted,

George Yungmann
Senior Vice President, Financial Standards

Christopher T. Drula
Senior Director, Financial Standards

cc: Ms. Susan Lloyd, Senior Director, Technical Activities, International Accounting Standards Board

Comment Letter Submitted by the

National Association of Real Estate Investment Trusts (United States), NAREIT

On behalf of the following members of the
Real Estate Equity Securitization Alliance (REESA):

Asian Pacific Real Estate Association, APREA

British Property Federation, BPF

European Public Real Estate Association, EPRA

National Association of Real Estate Investment Trusts (United States), NAREIT

Property Council of Australia, PCA

Real Property Association of Canada, REALpac

In response to the

Proposed Accounting Standards Update—*Consolidation (Topic 810): Principal versus Agent Analysis*

Issued by the

Financial Accounting Standards Board

November 3, 2011

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

February 15, 2012

Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Proposed Accounting Standards Update—*Consolidation (Topic 810): Principal versus Agent Analysis*

Dear Sir/Madam:

REESA is made up of seven representative real estate organizations around the world grounded in one or more facets of securitized real estate equity. REESA's broad mission is to improve the opportunities for investment in securitized real estate equity around the globe.

REESA strongly supports the harmonization of global accounting and financial reporting and understands the importance of achieving a high quality universal set of accounting standards. We have been fully engaged in the Boards' discussions on major convergence projects and have actively participated in meetings with the Boards and their staff with respect to these projects. REESA greatly appreciates the opportunities to express our global views through these meetings and comment letters.

One of REESA's goals is to achieve consistent financial reporting by companies that own and operate real estate. REESA has achieved significant consensus on over a dozen accounting standards proposed by the FASB and the International Accounting Standards Board (IASB) (collectively, the Boards) and has submitted comment letters that reflect these global consensus.

REESA commends and supports the Boards' efforts to continue to develop high-quality accounting standards and particularly supports the FASB's efforts to converge U.S. Generally Accepted Accounting Principles (GAAP) with International Financial Reporting Standards (IFRS).

REESA recognizes that differences remain in the FASB's and IASB's consolidation models. However, REESA embraces the changes that the FASB has proposed to align the guidance in US GAAP on determining principal versus agent (and related disclosures) with the guidance in IFRS. We believe that the Proposed Update will

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improve the comparability of financial statements and disclosures prepared in accordance with U.S. GAAP and IFRS. Therefore, REESA believes that the Proposed Update is a step in the right direction in order to achieve ultimate convergence of U.S. GAAP with IFRS at some point in the future.

We very much appreciate the Board's focus on the Consolidation proposal and the opportunity to share our views with the Board. We welcome the Board's questions on our comments.

Respectfully submitted,

Asia Pacific Real Estate Association

British Property Federation

European Public Real Estate Association

National Association of Real Estate Investment Trusts (United States)

Property Council of Australia

Real Property Association of Canada

Appendix I

REESA – The Real Estate Equity Securitization Alliance

REESA is made up of seven real estate organizations around the world grounded in one or more facets of securitized real estate equity. REESA's broad mission is to improve the opportunities for investment in securitized real estate equity around the globe. The REESA member organizations are:

- Asia Pacific Real Estate Association, APREA
- Association for Real Estate Securitization in Japan, ARES
- British Property Federation, BPF
- European Public Real Estate Association, EPRA
- National Association of Real Estate Investment Trusts, NAREIT®
- Property Council of Australia, PCA
- Real Property Association of Canada, REALpac

REESA has responded positively to the challenges presented by the developments in the global economy and, in particular, the global real estate markets. The benefits of collaboration on a global scale are increasingly valuable on major industry issues such as the sustainability of the built environment, tax treaties, corporate governance and research.

The formation of REESA was, in part, a direct response to the challenge and opportunity presented by the harmonization of accounting and financial reporting standards around the world. Given the size and importance of the real estate industry, our view is that there are considerable benefits to be gained by both accounting standard setters and the industry in developing consensus views on accounting and financial reporting matters, as well as on the application of accounting standards.

Since its formation REESA members have exchanged views on a number of accounting and tax related projects and shared these views with regulators and standards setters. These projects include:

- FASB/IASB Lease Accounting
- FASB/IASB Financial Statement Presentation
- FASB/IASB Reporting Discontinued Operations
- FASB/IASB Revenue Recognition
- FASB/IASB Effective Dates and Transition Methods
- IASB Fair Value Measurement
- IASB Income Tax
- IASB Real Estate Sales – IFRIC D21
- IASB Capitalization of Borrowing Costs – IAS 23
- IASB Accounting for Joint Arrangements – ED 9
- IASB Consolidated Financial Statements – ED 10
- IASB 2007/2008/2009 Annual Improvements to IFRS
- OECD developments on cross border real estate flows and international tax treaties

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

September 18, 2013

Technical Director
File Reference No. 2013-270
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Submitted via electronic mail to director@fasb.org

Re: FASB File Reference No. 2013-270, *Leases (Topic 842)*, a revision of the 2010 proposed FASB Accounting Standards Update, *Leases (Topic 840)* & IASB Exposure Draft – *Leases* (ED/2013/6)

Dear Sir/Madam:

This letter is submitted in response to the request for public comment by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) with respect to the FASB Proposed Accounting Standards Update (Revised) on *Leases (Topic 842) Leases* and the IASB Exposure Draft - *Leases* (ED/2013/6) (collectively, the Revised Proposed Updates).

NAREIT is submitting these comments on behalf of the following member organizations of the Real Estate Equity Securitization Alliance (REESA):

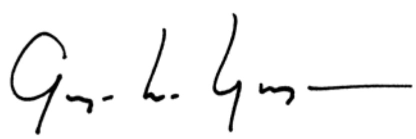
- Asia Pacific Real Estate Association (APREA)
- British Property Federation (BPF)
- European Public Real Estate Association (EPRA)
- National Association of Real Estate Investment Trusts in the United States (NAREIT®)
- Property Council of Australia (PCA)
- Real Property Association of Canada (REALpac)

REESA is a global alliance of representative real estate organizations and seeks to promote equity investment in real estate on a securitized basis. Together, the members of REESA represent the vast majority of constituent companies in the FTSE EPRA/NAREIT Global Real Estate Index. REESA focuses on cross-border investment, international taxation, financial reporting standards initiatives and education outreach to investors. REESA members represent major operating real estate companies (including REITs) – companies that acquire, develop, lease, manage and opportunistically sell investment property.[1]

Members of the organizations identified above would be pleased to meet with the Boards or staff to discuss any questions regarding our comments on the Revised Proposed Updates.

We thank the Boards for the opportunity to provide further input on the Revised Proposed Updates. If you would like to discuss our comments, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at 202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at 202-739-9442.

Respectfully submitted,



George Yungmann
Senior Vice President, Financial Standards

Christopher Drula
Vice President, Financial Standards

[1] REESA's broad mission is to improve the opportunities for investment in securitized real estate equity around the globe. The purpose and activities of REESA are discussed further in Appendix I.

REESA comments and recommendations on FASB File Reference No. 2013-270, *Leases (Topic 842)*, a revision of the 2010 proposed FASB Accounting Standards Update, *Leases (Topic 840)* & IASB Exposure Draft – *Leases* (ED/2013/6)

Preserve the Type B Lease Accounting Model for Property that Recognizes Lease Income on a Straight-line Basis

REESA commends the Boards for their extensive consultation and thoughtful response to our comments. We strongly support the Revised Proposed Updates to allow most lessors of property to continue to recognize the full rental income and underlying property. Total lease income and the visibility over the underlying property are fundamental for investors to be able to assess the performance and investment quality of property companies. This view has been communicated via a submission to the Boards from global real estate investors and industry analysts, and is included as Appendix II to this letter. Removing these metrics would adversely impact the information that property companies communicate to investors, financial analysts and other users of financial statements and would represent a major step backwards in the global industry's efforts to provide meaningful information to financial statement users. In this respect, the proposed model for property is a clear improvement on the model originally proposed in the first exposure draft.

The Revised Proposed Updates would provide financial statement users with information that faithfully represents the underlying economics of *most* property leases for lessors/landlords. As outlined in previous submissions[2] as well as discussions with the Boards and staff, we do not believe that the receivable and residual lessor accounting model is operational for investment property.

Our discussions with real estate analysts reveal that analysts would be forced to unwind the accounting results from the receivable and residual model to effectively evaluate the investment quality of our member companies. This is a significant concern, as analysts would be making buy or sell recommendations based on unaudited financial information provided by our member companies.

We therefore urge the Boards to collaborate on a converged accounting model for property that preserves:

- the property as a single unit of account on balance sheet;
- the recognition of lease income on the income statement generally on a straight-line basis; and,
- the option to present the fair value of right-of-use assets that meet the definition of investment property on the balance sheet in accordance with International Accounting Standard 40 *Investment Property*.

[2] http://www.reit.com/Portals/0/PDF/REESACommentLetter07112011.pdf

We understand that certain of the Boards' constituents may advocate that all leases be accounted for under a single approach. REESA would not object to this conclusion and would fully support it so long as the single approach mirrors the currently proposed approach for Property or Type B leases. In addition, we believe that the vast majority of financial statement preparers and users support the straight-line lease expense pattern yielded by the approach proposed for Type B leases.

We caution the Boards that a conclusion to provide only one approach to accounting for all leases that would require the proposed accounting for Type A leases would not be operational for lessors of multi-tenant investment property. The basis for this view is thoroughly discussed in REESA's July 11, 2011 submission to the Boards[3].

Additional Enhancements to the Revised Proposals

REESA recommends that the Boards consider the following enhancements to the Revised Proposals:

Clearly articulate the definition of "lease term"

REESA concurs with the Revised Proposal that defines the lease term as the non-cancellable period for which a lessee has the right to use the property.

However, we recommend that the current concept of 'reasonably certain' be retained because:

- the Board has acknowledged in BC 140 that the current concept works well in practice and the threshold is expected to be similar to the current concept of 'reasonably certain'; and,

- the definition of 'significant economic incentive' may be less clear than 'reasonably certain.'

We understand that the Boards are concerned that entities would structure shorter term leases with more renewals. However, there is an economic disincentive for lessees to do this as lessors would be able to reset rental payments to the then-current market rent, which would generally increase the fixed rental payments.

In addition, it is common for new lease incentives to be negotiated when the terms of a renewal are being negotiated. In our view, recognizing the lease incentive on a straight-line basis beyond the non-cancellable period of the lease is inappropriate.

Further, REESA is concerned about the continuous reassessment of the lease term. While the

[3]http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175822733314&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs

Revised Proposals only require reassessment when a lessee has, or no longer has a significant economic incentive to renew, or terminate a lease, we question whether practically this is any different to requiring a reassessment at each reporting date.

Classify leases based on the comparison of lease term to the total economic life, rather than to the remaining economic life

REESA agrees with the Revised Proposal that would require the comparison of the lease term to the economic life of the property and the lease payments to the fair value of the property as an appropriate basis for determining whether or not a lessor should apply Type B accounting**.** However, the lease term should be compared to the total economic life, rather than the remaining economic life of the property.

While this scenario is unlikely to arise frequently in the real estate industry, it is not appropriate for a five year lease of property with a ten year remaining economic life to be recognized differently from a five year lease of property with a five year remaining economic life (where the total economic life of both properties was originally 50 years).

Rental payments made by the tenant to the landlord relate partly to the floor space being occupied, but also more significantly to the location of the property. This is demonstrated through different rates per square metre being charged for properties of the same quality in different locations. The value of the location continues to exist at the end of the building's economic life and the landlord holds the residual interest in the property. This enables redevelopment should the landlord choose which would further extend the economic life of the building.

It would therefore not be appropriate to reflect a five year lease of property with a five year remaining economic life (where the total economic life was originally 50 years) as a type A lease, unless the present value test is met.

Assessment of land and buildings together

We agree with paragraphs 842-10-25-9 (FASB exposure draft (FASB ED)) and 33 (IASB exposure draft (IASB ED)) that land and buildings should be assessed together for the purpose of determining the appropriate classification of a lease. However, we are concerned that the Revised Proposed Updates would require the economic life of the building would always be considered to be the economic life of the underlying asset for the purposes of classifying the lease. There are circumstances in which the land element is significantly more valuable than the building. In these cases, it is incorrect to default to the remaining economic life of the building because the land is the more valuable underlying asset and represents the primary asset.

Therefore, we recommend that the guidance in paragraphs 842-10-25-10 (FASB ED) and 33 (IASB ED) be deleted from the final standards. This would ensure that preparers are able to apply the principles in paragraphs 842-10-25-9 (FASB ED) and 33 (IASB ED) in making the determination of the primary asset when a lease contains multiple elements.

Consistently apply the consumption principle to long-term land leases

It is common for real estate companies to lease land under land-only leases, especially in central business districts and other areas where land is owned by local governments. Many of these long-term leases may meet the proposed criteria that define a Type A lease based on the relationship between the present value of the lease payments and the fair value of the land at the lease commencement date. Classifying these long-term land leases as Type A leases is clearly contrary to the overarching consumption principle in the Proposal.

The conclusion that a lease of land should invariably be classified as a Type B lease is also supported by the following discussion taken from the Snapshot: Leases published by IFRS in May 2013[4]:

> *A lessee that enters into a Type A lease, in effect, acquires the part of the underlying asset that it consumes, which is typically paid for over time in the form of lease payments. Accordingly, a lessee would present amortization of the right-of-use asset in the same line item as other similar expenses (for example, depreciation of property, plant, and equipment) and interest on the lease liability in the same line item as interest on other, similar financial liabilities.*
>
> *In contrast, the lease payments made in a Type B lease would represent amounts paid to provide the lessor with a return on its investment in the underlying asset, i.e., a charge for the use of the asset. That return or charge would be expected to be relatively even over the lease term. Accordingly, those payments for use are presented as one amount in a lessee's income statement and recognized on a straight-line basis.*
> *The presentation of cash outflows in the cash flow statement is consistent with the presentation of expenses in the income statement. For Type A leases, the principal portion of cash payments is presented within financing activities and the interest portion within operating or financing activities. Cash payments for Type B leases are presented as one.*

REESA believes that the accounting described above supports the conclusion that land leases represent Type B leases based on the consumption principle.

Further, under current US GAAP, land only leases are considered operating leases unless it is probable that a purchase option would be exercised. One indication that this would occur would be the existence of a bargain purchase option at the end of the lease term.

We understand that the Boards discussed the accounting for long-term land leases at some point in the process of developing a converged leases standard. We believe that the conclusion reached at that time was made prior to the Boards' conclusion to use the consumption principle to distinguish Type A and Type B leases. We urge the Boards to reconsider its conclusion with respect to accounting for land-only leases and strongly recommend that the final standard

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[4] http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Exposure-Draft-May-2013/Documents/Snapshot-Leases-May-2013.pdf

require that all land leases be classified and accounted for as Type B leases consistent with the Proposal's consumption principle.

At the same time, REESA strongly supports the lessee requirement in the IASB ED for leases to be reported as investment property under IAS 40. Paragraph 35 of the IASB ED makes clear that a lessee shall not classify a lease as a Type A or a Type B lease if it chooses to measure the ROU asset in accordance with the fair value model in IAS 40.

REESA – The Real Estate Equity Securitization Alliance

REESA is made up of seven real estate organizations around the world grounded in one or more facets of securitized real estate equity. REESA's broad mission is to improve the opportunities for investment in securitized real estate equity around the globe. The REESA member organizations are:

- Association for Real Estate Securitization in Japan (ARES)
- Asia Pacific Real Estate Association (APREA)
- British Property Federation (BPF)
- European Public Real Estate Association (EPRA)
- National Association of Real Estate Investment Trusts in the United States (NAREIT®)
- Property Council of Australia (PCA)
- Real Property Association of Canada (REALpac)

REESA has responded positively to the challenges presented by the developments in the global economy and, in particular, the global real estate markets. The benefits of collaboration on a global scale are increasingly valuable on major industry issues such as the sustainability of the built environment, tax treaties, corporate governance and research.

The formation of REESA was, in part, a direct response to the challenge and opportunity presented by the harmonization of accounting and financial reporting standards around the world. Given the size and importance of the real estate industry, our view is that there are considerable benefits to be gained by both accounting standard setters and the industry in developing consensus views on accounting and financial reporting matters, as well as on the application of accounting standards.

Since its formation REESA members have exchanged views on a number of accounting and tax related projects and shared these views with regulators and standards setters. These projects include:

- FASB *Investment Companies*
- FASB *Investment Property Entities*
- IASB *Investment Entities*
- FASB *Consolidation: Principle versus Agent Analysis*
- IASB *Agenda Consultation 2011*
- FASB/IASB *Accounting for Leases*
- FASB/IASB *Financial Statement Presentation*
- FASB/IASB *Reporting Discontinued Operations*
- FASB/IASB *Revenue from Contracts with Customers*
- FASB/IASB *Effective Dates and Transition Methods*
- IASB *Fair Value Measurement*
- IASB *Income Tax*

♦

- IASB *Real Estate Sales – IFRIC D21*
- IASB *Capitalization of Borrowing Costs – IAS 23*
- IASB *Accounting for Joint Arrangements – ED 9*
- IASB *Consolidated Financial Statements – ED 10*
- IASB *2007/2008/2009 Annual Improvements to IFRS*
- OECD developments on cross border real estate flows and international tax treaties

Appendix II

EUROPEAN PUBLIC REAL ESTATE ASSOCIATION

13 September 2013

International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116

Re: FASB File Reference No. 2013-270, *Leases (Topic 842)*, a revision of the 2010 proposed FASB Accounting Standards Update, *Leases (Topic 840)* & IASB Exposure Draft – *Leases* (ED/2013/6)

Dear Sir/Madam,

We are pleased to submit this letter on the International Accounting Standards Board's (IASB) and Financial Accounting Standards Board's (FASB) (collectively "the Boards") Exposure Draft: Leases. We are submitting these comments on behalf of the undersigned investors and property sector analysts. As major investors into property and investment property companies (including REITs) these financial statement users have a strong interest in ensuring that the reporting related to investment property is relevant and transparent.

Recognition of investment property and rental income in line with current IFRS

We are fully supportive of the conclusion reached by the Boards to allow lessors of investment property to continue to recognise the investment property on the lessor's Balance Sheet and full rental income on the lessor's Income Statement for the vast majority of leases. The proposed accounting provides decision-useful information on which to base our evaluation of the investment quality of investment properties and companies that own and operate portfolios of investment property. In addition, the proposed accounting is broadly consistent with current accounting guidance for most commercial real estate leases under both IFRS and U.S. GAAP.

As stated in our letter of November 2010, information regarding the full amount of rental income is fundamental to investors in assessing the performance and investment quality of investment property companies. That is why International Accounting Standard No 40 *Investment Property* (IAS 40) is well supported by industry financial statement preparers reporting under IFRS and industry financial statement users. It requires a property company to disclose the fair value of its property and reports full rental income in the profit and loss account.

We acknowledge the Boards' recognition of IAS 40 in the proposed guidance for accounting by lessees that control property through leasehold interests. Under the proposed accounting, companies that lease property that qualifies as investment property under IAS 40 would be accounted for as investment property. This would include the choice to report these properties at fair value.

Finally, we want to reiterate our previously expressed view that removing the visibility over the investment property, as well as the full rental income, would represent a step backward in terms of investment property companies communicating effectively the profitability and financial position of the company to investors, analysts, and other users.

The investors identified below would be pleased to meet with the Boards or staff to discuss in more detail the views of users of the financial statements of investment property companies.

If you would like to discuss this matter with us, please contact either Andrew Saunders at andrew.saunders@epra.com or George Yungmann at gyungmann@nareit.com.

We thank the FASB and IASB for the opportunity to comment on the Boards' Exposure Drafts with respect to this very important project.

Respectfully submitted,

Investment institutions

Name	Organisation	Property AUM (€million)	E-mail
John Robertson	RREEF	36,700	CONTACT DETAILS PROVIDED SEPARATELY
Guido Bunte	Cornerstone Real Estate Advisers	29,600	
Roger Lees	Aviva Investors	28,500	
Rafael Torres Villalba	All Pension Group (APG)	25,000	
Marc Halle	Pramerica/Prudential	23,400	
Rogier Quirijns	Cohen & Steers	22,300	
Alex Jeffrey	M&G Real Estate	19,000	
Simon Robson	CBRE Clarion Securities	17,400	
Hans Op 't Veld	PGGM Investments	15,400	
Timothy Pire	Heitman	15,300	
Patrick Sumner	Henderson Global Investors	13,000	
Theodore Bigman	Morgan Stanley Investment Management	12,100	

Investment institutions contd.

Bill Hughes	Legal & General Property	10,900	CONTACT DETAILS PROVIDED SEPARATELY
Andrew Jackson	Standard Life Investments	10,400	
Craig Mitchell	Dexus Property Group	9,400	
Saker Nusseibeh	Hermes Real Estate Inv Management	6,500	
Robert Oosterkamp	AEW Global Advisors	6,030	
Stephen Tross	Bouwinvest REIM	6,000	
James Rehlaender	European Investors, Inc	5,100	
Jan Willem Vis	BNP Paribas Investment Partners	3,000	
Jos Short	Internos Global Investors	2,000	
Mark Townsend	Asset Value Investors	1,800	
Frank Haggerty	Duff & Phelps Investment Management	1,400	
Steven Brown	American Century Investments	1,400	
Matthijs Storm	Kempen & Co	1,100	
Vincent Bruyère	Degroof Fund Management Company	250	
Charles Fitzgerald	V3 Capital Management LP	190	

Investment analysts

Name	Organisation	Email
John Lutzius, Mike Kirby	Greenstreet Advisors	CONTACT DETAILS PROVIDED SEPARATELY
Harm Meijer	JP Morgan	
Bart Gysens	Morgan Stanley	
Jan Willem van Kranenburg	ABN AMRO	
Alex Moss	Consilia Capital	
Nick Webb	Exane BNP Paribas	
Steven Sakwa	ISI Group	

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

June 30, 2015

Ms. Susan Cosper
Technical Director
File Reference No. 2015-250
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Delivered Electronically

Re: Proposed Accounting Standards Update *Revenue from Contracts with Customers (Topic 606) Identifying Performance Obligations and Licensing*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) to provide input on the Proposed Accounting Standards Update *Revenue from Contracts with Customers (Topic 606) Identifying Performance Obligations and Licensing* (the Proposal or ED). This letter provides comment only on the issue of clarifying the guidance on when promised goods and services are distinct for purposes of identifying performance obligations.

NAREIT agrees that the Financial Accounting Standards Board (FASB or Board) should clarify the guidance for identifying performance obligations. However, we do not believe that the proposed clarifications (or the original language in Topic 606) provide sufficient clarity on an issue of great importance to our member companies – whether commitments by the lessor/landlord to pay property taxes, maintain insurance, and provide common area maintenance related to leased real estate should be treated as being distinct from the obligation to provide the leased space to the lessee. We therefore request that the FASB clarify that such obligations are not distinct from the leased space either through an example or revised wording as it finalizes the amendments proposed in the ED, and make corresponding changes for the accounting guidance on separating lease and non-lease components that is included within the Proposed *Leases* standard.

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing diversification, dividends, liquidity and transparency to investors through their businesses that operate in all facets of the real estate economy.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. All REITs Index which covers both Equity REITs and Mortgage REITs. This Index contained 221 companies representing an equity market capitalization of $926 billion at April 30, 2015. Of these companies, 180 were Equity REITs representing 93.3% of total U.S. stock exchange-listed REIT equity market capitalization (amounting to $864 billion)[1]. The remainder, as of April 30, 2015, is represented by 41 stock exchange-listed Mortgage REITs with a combined equity market capitalization of $62 billion.

NAREIT Comments

NAREIT concurs that the guidance in Topic 606 on determining whether promised goods or services are "distinct in the context of the contract" would benefit from additional clarity. NAREIT's main focus relating to the identification and separation of performance obligations has been voiced in previous comment letters submitted in response to both the *Revenue Recognition* and *Leases* Proposals. The issue that NAREIT identified deals with whether lessor commitments to pay property taxes, maintain insurance and perform common area maintenance should be bifurcated from revenue from space rent. Preparers and auditors have questioned whether this was the Board's intention when the Board deliberated the separation of performance obligations in the new *Revenue from Contracts with Customers* standard as well as the separation of lease and non-lease components in the new *Leases* proposal.

Based on our reading of the current *Leases* revised exposure draft, lease revenue may be required to be separated between lease and non-lease components. Lease components would be subject to the new *Leases* accounting guidance, while non-lease components would be subject to the new *Revenue from Contracts with Customers* standard. Because Topic 606 may require that revenue within its scope be presented separately from other revenue, separation would effectively result in a need to present lease revenue separately from revenue from the related tax, insurance and CAM services.

In our view, commitments to pay taxes, maintain insurance, and perform common area maintenance that are included in a lease agreement are highly interdependent and highly

[1] https://www.reit.com/sites/default/files/reitwatch/RW1505.pdf at page 21.

interrelated[2] with the use of the leased real estate. The lessee would not be able to use the leased space in an office building or a shopping center if the real estate:

- was subject to a tax lien,
- did not have an active insurance policy to satisfy its debt agreement on the property, or
- was not properly maintained.

The purpose of the transaction is to lease space in exchange for market rent. Lessees cannot go to the market and separately contract for tax collection services, separate insurance contracts for the structure of a specific office space on/within a floor of a building, or contract with cleaning and maintenance services to clean the common area contiguous to the tenant's space. Given the highly interrelated nature of the tenant reimbursements and the space rent, we believe that the income statement should reflect all of these payments in a single line item[3]. While we believe that the application of the principles of Topic 606, as issued, does not require that such promises be treated as performance obligations distinct from the leased space, some audit firms have espoused different views. As such, while we believe the language in the Proposal also would not require tax, insurance and CAM commitments to be treated separately, we are concerned that differing views will continue.

In order to ensure proper application of the new *Leases* and *Revenue from Contracts with Customers* standards, NAREIT recommends that the Board include an illustrative example that demonstrates how the standards would apply to lease agreements containing tenant reimbursements. NAREIT would be happy to assist the Board in developing an illustration consistent with market realities for inclusion in the final standards.

We thank the FASB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 202-739- 9442.

[2] http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176166005104&acceptedDisclaimer=true at paragraph 606-10-25-21(c).

[3] In order to meet the needs of investors, NAREIT believes that components of lease revenue that vary directly with related costs (as is often the case is a so-called "net lease", in which a fee is stated for the leased space, with allocations of applicable costs paid in addition to that stated fee) should be disclosed in the notes to the financial statements. To the extent that the lease agreement includes a single rental payment, with no additional amounts paid for allocation of common costs, NAREIT believes the needs of investors would be met with disclosure of the costs incurred for these items, as opposed to requiring an artificial bifurcation of revenue. In our view, these disclosures would adequately convey information about the risks either taken on by the lessor, or passed on to the lessee.

Respectfully submitted,

George L. Yungmann
Senior Vice President, Financial Standards

Christopher T. Drula
Vice President, Financial Standards

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

September 12, 2013

Ms. Susan Cosper
Technical Director
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PO Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Delivered Electronically

Re: File Reference No. 2013-270, *Leases (Topic 842)*, a revision of the 2010 proposed FASB Accounting Standards Update, *Leases (Topic 840)*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the Proposed Accounting Standards Update (Proposed ASU or the Proposal) from the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) combined (the Boards) *Leases*.

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index, which covers both Equity REITs and Mortgage REITs. This Index contained 189 companies representing an equity market capitalization of $670.4 billion[1] at June 30, 2013. Of these companies, 150 were Equity REITs representing 90.7% of total U.S. listed REIT equity market capitalization (amounting to $608.3 billion). The remainder, as of June 30, 2013, was 39 publicly traded Mortgage REITs with a combined equity market capitalization of $62.1 billion.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices Council (the Council). Members of the task force include financial executives of both Equity and Mortgage REITs, representatives of major accounting firms, institutional investors and industry analysts. The financial executives representing Equity REITs are involved in all property sectors of the REIT industry – regional malls, shopping centers, multi-family residential, office, health care, lodging/resorts and industrial. These task force members have a working knowledge of leases related to all of these property types.

NAREIT is a member of the global Real Estate Equity Securitization Alliance (REESA) and supports the views expressed in this organization's comment letter submitted to the Boards.

Executive Summary

NAREIT and its global partners represented in REESA have been active in the Boards' process toward developing a high quality converged standard for accounting and reporting for leases. We have provided input to the Boards and staff on several occasions, through face-to-face meetings with the Boards, through meetings of the Boards, through participation on the Boards' leases working group and via comment letters on the Boards' various proposals. Additionally, NAREIT and REESA have provided support for the Boards' staff on tentative decisions during the Boards' re-deliberations process.

All of this input to the Boards has had one purpose – to achieve an accounting and reporting model that would provide enhanced decision-useful information to our industry's global financial statement users.

The Boards' Response to this Global Real Estate Industry Input

We acknowledge the Boards' thoughtful response to all of the input provided by NAREIT and REESA. While we have a number of suggested modifications to the proposed accounting and reporting model, we strongly support the Boards' conclusions with respect to the property, Type B, model. We believe that this model would provide financial statement users with information that faithfully represents the underlying economics of a landlord's economic position in the great majority of property leases.

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[1] http://returns.reit.com/reitwatch/rw1307.pdf at page 21

The Possibility of One Approach to Lease Accounting

We understand that certain constituents of the Boards may advocate that all leases be accounted for under a single approach. NAREIT would not object to this conclusion and would fully support it so long as the single approach mirrors the currently proposed approach for Property or Type B leases. We believe that the vast majority of financial statement preparers and users support the straight-line lease expense pattern yielded by the approach proposed for Type B leases.

We caution the Boards that a conclusion to provide only one approach to accounting for all leases that would require the proposed accounting for Type A leases would not be operational for lessors of multi-tenant investment property. The basis for this view is thoroughly discussed in REESA's July 11, 2011 submission to the Boards[2].

Recommended Modifications to the Proposed ASU

Accounting for Land-Only Leases

It is common for real estate companies to lease land under land-only leases, especially in central business districts and other areas where land is owned by local governments. Then, real estate companies typically develop buildings and related improvements that they lease to third parties. Many of these long-term land-only leases may meet the proposed criteria that define a Type A lease based on the relationship between the present value of the lease payments and the fair value of the land at the lease commencement date. However, classifying these long-term land leases as Type A leases is clearly contrary to the overarching consumption principle in the Proposal.

A conclusion that a lease of land should be accounted in accordance with the guidance provided for Type B leases is fully supported by the following discussion taken from the *Snapshot: Leases* published by IFRS Foundation in May 2013 [3]:

> *A lessee that enters into a Type A lease, in effect, acquires the part of the underlying asset that it consumes, which is typically paid for over time in the form of lease payments. Accordingly, a lessee would present amortization of the right-of-use asset in the same line item as other similar expenses (for example, depreciation of property, plant, and equipment) and interest on the lease liability in the same line item as interest on other, similar financial liabilities.*
>
> *In contrast, the lease payments made in a Type B lease would represent amounts paid to provide the lessor with a return on its investment in the underlying asset, i.e. a charge for the use of the asset. That return or charge would be expected to be relatively even over the lease term. Accordingly, those payments for use are presented as one amount in a lessee's income statement and recognized on a straight-line basis.*

[2]http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175822733314&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs

[3] http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Exposure-Draft-May-2013/Documents/Snapshot-Leases-May-2013.pdf

> *The presentation of cash outflows in the cash flow statement is consistent with the presentation of expenses in the income statement. For Type A leases, the principal portion of cash payments is presented within financing activities and the interest portion within operating or financing activities. Cash payments for Type B leases are presented as one.*

NAREIT believes that the accounting described in the IFRS Foundation *Snapshot: Leases* above supports the conclusion that land leases represent Type B leases based on the consumption principle.

Recommendation

NAREIT understands that the Boards discussed the accounting for long-term ground leases at some point in the process of developing a converged leases standard. We believe that the conclusion reached at that time was made prior to the Boards' conclusion to use the consumption principle to distinguish Type A and Type B leases. We urge the Boards to reconsider their conclusion with respect to accounting for land-only leases and strongly recommend that the final standard require that all ground leases be classified and accounted for as Type B leases consistent with the Proposal's consumption principle.

Accounting and Reporting for Tenant Reimbursements of Landlord Costs

A significant issue raised by the Proposed ASU is how the Proposal would impact the accounting for *tenant reimbursables* paid to a landlord for the landlord's costs of maintaining *landlord's property* – property required to allow tenants to benefit from space leased from landlord. These costs represent a portion of the tenant's total cost to occupy his/her specific space – the right-of-use asset. The Proposed ASU defines *lease payments* as *payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term.* Tenant reimbursements of landlord's costs to maintain the common elements of a commercial real estate property are directly related to the tenant's right to use the tenant's space. For example, a tenant could not achieve the economic benefits of his specific space in a retail center without the property's parking lot, common areas of the center, elevators and the like. None of these tenant reimbursables represent payments for services to the tenant or to the tenant's space – the asset underlying the ROU. NAREIT therefore believes that these tenant reimbursements of landlord's costs to maintain common elements of the property represent *lease payments* and should be reported as lease income.

These tenant reimbursables of landlord's costs to maintain the landlord's property would not include payments to the landlord for non-lease services. For example, payments by the tenant for landlord services to maintain *tenant's space* (the underlying asset) or to provide services that are not directly related to the tenant's occupancy of space would represent non-lease income and be accounted for under the Boards' revenue recognition standard.

Recommendation

There has been significant debate among industry participants and accounting firms as to the accounting for tenant reimbursables of landlord costs under the Proposed ASU. We, therefore, suggest that the Boards clarify the accounting for these reimbursements of *landlord's costs associated with landlord's property.*

Reporting under Both Type A and Type B Leases

While the great majority of property leases would qualify as Type B leases, a real estate company may lease some properties under leases that meet the definition of a Type A lease. This situation raises two significant issues.

First, the model of applying the receivable and residual approach to a simple multi-tenant office building, which we created and shared with the Boards' Leases staff, clearly illustrated to us and to the staff that this approach to lessor accounting would not be operational for multi-tenant properties. This situation would be exacerbated if the investment property is carried at fair value.

Second, the reporting for leases based on two lessor accounting models in a company's financial statements would be very confusing to financial statement users.

Recommendation

We recommend that the Boards eliminate this potential reporting issue by requiring that all leases of property be considered Type B leases.

Further Consider the Definition of Property

We believe the Boards have narrowed the definition of *property* to a significant extent. We recommend that the Boards further consider its definition in the Proposed ASU and clarify the Proposal's definition.

Under current U.S. GAAP, "integral equipment" that is subject to a lease is treated as real estate. The FASB Codification Manual Master Glossary defines integral equipment as "any physical structure or equipment attached to real estate that cannot be removed and used separately without incurring significant cost[4]." Therefore, structures such as cell towers are treated as real estate under current U.S. GAAP.

The Proposal introduces a new definition of *property* that would represent a fundamental change to the revenue recognition pattern for leases related to cell towers and similar property. Because these assets would not be considered "land, building, or parts of a building," leases of this property would be classified as Type A leases. In our view, leases of these types of assets should be accounted for as property – not equipment; they are long-lived permanent structures that are

[4] https://asc.fasb.org/glossary&letter=I

attached to the ground. We believe that clarifying the definition of "property" to include "integral equipment" would provide a more principles-based approach to lease classification.

NAREIT continues to support the Boards' efforts to develop a converged global standard for lease accounting and would welcome an opportunity to discuss our views on the Proposed ASU with the Boards. If there are questions regarding this comment letter, please contact either George Yungmann at 202-739-9432 or gyungmann@nareit.com or Christopher Drula at 202-739-9442 or cdrula@nareit.com.

Respectfully submitted,

George L. Yungmann
Senior Vice President, Financial Standards

Christopher T. Drula
Vice President, Financial Standards

cc: Paul Beswick, Chief Accountant, Securities and Exchange Commission

NATIONAL
ASSOCIATION
OF
REAL
ESTATE
INVESTMENT
TRUSTS®

January 21, 2016

Ms. Susan M. Cosper
Technical Director
File Reference No. 2015-330
Financial Accounting Standards Board
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Delivered electronically

RE: Proposed Accounting Standards Update – *Business Combinations (Topic 805) – Clarifying the Definition of a Business*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) to provide input on the Proposed Accounting Standards Update – *Business Combinations (Topic 805) – Clarifying the Definition of a Business* (the Proposal).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing diversification, dividends, liquidity and transparency to investors through their businesses that operate in all facets of the real estate economy.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index which covers both Equity REITs and Mortgage REITs. This Index contained 225 companies representing an equity market capitalization of $935 billion at November 30, 2015. Of these companies, 184 were Equity REITs representing

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Phone 202-739-9400 Fax 202-739-9401 REIT.com

94.1% of total U.S. stock exchange-listed REIT equity market capitalization (amounting to $880 billion)[1]. The remainder, as of November 30, 2015, is represented by 41 stock exchange-listed Mortgage REITs with a combined equity market capitalization of $55 billion.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices Council (the Council). Members of the task force include financial executives of both Equity and Mortgage REITs, representatives of major accounting firms, institutional investors and industry analysts.

NAREIT supports the Board's objective

NAREIT supports the Board's objective in addressing constituent concerns that the definition of a business in current U.S. GAAP is applied too broadly, resulting in many transactions qualifying as businesses while purchasers view them as asset acquisitions. This phenomenon has been pervasive in the real estate industry since the implementation of FAS 141(R) where the acquisition of even a single property by a REIT is generally required to be accounted for as a business combination. Further, preparers and auditors have struggled to understand why the acquisition of an investment property is accounted for as a business combination, but treated as an asset disposition upon sale of the investment property (a sale of real estate).

What adds further complexity to the asset versus business determination is the difference in application by companies that report pursuant to U.S. GAAP and International Financial Reporting Standards (IFRS). Despite the fact that the words in GAAP and IFRS are identical, real estate companies across the globe that report under IFRS generally account for acquisitions of investment properties as asset acquisitions, while companies that report under U.S. GAAP account for the same types of transactions as business combinations. NAREIT appreciates the Board's efforts to address this divergence in application.

NAREIT Recommendation – Align the accounting guidance for business combinations with existing asset acquisition guidance

While NAREIT appreciates the Board's efforts in pursuing clarified guidance to address what constitutes an asset versus a business, NAREIT believes that the Board could achieve its objective in a much simpler manner. Rather than redefining what would qualify as a business, NAREIT strongly believes that the board should align the accounting guidance for business combinations with existing asset acquisition guidance. A major difference between business combinations guidance and asset acquisition guidance under today's GAAP is whether acquisition transaction costs are capitalized or expensed. NAREIT believes that eliminating this difference by requiring the capitalization of acquisition costs whether a transaction is considered an asset acquisition or a business combination would provide the following benefits to both the preparer and user community alike:

[1] https://www.reit.com/sites/default/files/reitwatch/RW1512.pdf at page 21.

- Simplify accounting by eliminating a need for an evaluation of what constitutes an asset acquisition or a business combination;

- Help converge the accounting results for acquisitions of investment property as between IFRS and U.S. GAAP;

- Mirror the accounting for real estate acquisitions with economics of the transaction; and,

- Eliminate the need by financial statement users in the real estate industry to reverse the expensing of acquisition costs when evaluating the economic earnings prospects of real estate companies.

Other Comments

In the event that the Board decides to pursue the issuance of the Proposal, NAREIT recommends the following clarifications to the Proposal:

- Clarify the wording in paragraph 805-10-55-78 to include the italicized terms below:

    - Although the leases are at market *rates*, REIT concludes that the fair value of the in-place lease *intangible asset is* significant and that the fair value of the gross assets acquired is not concentrated in either the leases or the tangible assets.

        - Without these changes, the wording leads the reader to believe that the analysis would compare the fair value of in-place leases with the fair value of the operating property. This is a circular analysis, given that the fair value of the building is measured by the present value of cash flows to be received under in-place leases.

- Amend the criteria for the evaluation of similar asset types to include a comparison of the types of assets acquired with the acquirer's existing portfolio of assets.

    - For example, if a real estate company that owns and manages a portfolio of office buildings and, therefore has an operating platform focused on office buildings, acquires office properties to add to its portfolio, the acquisition should be accounted for as an asset purchase.

    - Further, some REITs do not own and operate a single asset type. NAREIT groups these REITs into the diversified sector (*e.g.,* a REIT that owns shopping malls, parking lots, and apartment buildings). Many times, these different types of properties are acquired together in single transactions. We believe that the acquisition of different types of assets should be accounted for as an asset acquisition to the extent that the transaction is consistent with the acquirer's business model. If the Board does not provide this clarification, the preparer may be left to debate with his or her auditor whether this acquisition represents similar assets or multiple assets which could provide an uneconomic result that the transaction should be accounted for as a business combination (particularly noting that if acquired separately, they would be asset acquisitions).

- Add guidance that clarifies that the acquisition of multiple properties that are in various stages of development would still be considered similar assets.

    - Along the same lines as the preceding bullet, REITs can acquire a group of assets that are in various stages of development (*e.g.*, buildings under construction, vacant buildings, and operating properties). NAREIT recommends that the Board clarify that a transaction that includes properties at different stages of development would be considered similar in nature. The business purpose of acquiring the group of assets serves the same purpose – to add investment property to the company's current portfolio of investment properties. In our view, the economics of the transaction is more akin to an asset acquisition than a business combination.

NAREIT continues to support the FASB's *Clarifying the Definition of a Business* Project. If there are questions regarding this comment letter, please contact either George Yungmann at 202-739-9432 or gyungmann@nareit.com or Christopher Drula at 202-739-9442 or cdrula@nareit.com.

Respectfully submitted,

George L. Yungmann
Senior Vice President, Financial Standards

Christopher T. Drula
Vice President, Financial Standards

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 29, 2015

Ms. Susan Cosper
Technical Director
File Reference No. 2015-240
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Delivered Electronically

Re: Proposed Accounting Standards Update *Revenue from Contracts with Customers (Topic 606) Deferral of Effective Date*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) to provide support and input to the Proposed Accounting Standards Update *Revenue from Contracts with Customers (Topic 606) Deferral of Effective Date* (the Proposal). For reasons discussed further below, NAREIT agrees that the Financial Accounting Standards Board (FASB or Board) should defer the effective date of *Revenue from Contracts with Customers* Standard (the *Revenue Recognition* Standard).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing diversification, dividends, liquidity and transparency to investors through their businesses that operate in all facets of the real estate economy.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. All REITs Index, which covers both

Equity REITs and Mortgage REITs. This Index contained 220 companies representing an equity market capitalization of $966 billion at March 31, 2015 Of these companies 179 were equity REITs representing 93.6% of total U.S. stock exchange-listed REIT equity market capitalization (amounting to $904 billion)[1]. The remainder, as of March 31, 2015, is represented by 41 stock exchange-listed mortgage REITs with a combined equity market capitalization of $62 billion.

NAREIT Recommendation

NAREIT concurs with the Proposed Deferral of the *Revenue Recognition* Standard. While NAREIT does not have a strong preference for a one year or two year deferral, NAREIT recommends that the Board align the effective date with that of other standard setting on the Board's agenda that will impact the real estate industry (*i.e., Leases, Clarifying the Definition of a Business*, and *Revenue Recognition – Identifying Performance Obligations and Licenses* Projects).

Revenue Recognition and Leases Projects

Through our evaluation of exposure drafts and observing the Boards' ongoing re-deliberations, NAREIT has identified the following examples where the *Revenue Recognition* and *Leases* Projects are interrelated:

- Scope - The *Revenue Recognition* Standard clearly excludes leases from the scope of the standard. Similarly, if a contract does not meet the definition of a lease within the *Leases* Proposal, then the contract would probably be subject to the *Revenue Recognition* Standard for the party providing the service.

- Accounting for Sales-type Leases by Manufacture/Dealers – While leases are outside the scope of the new *Revenue Recognition* Standard, accounting for sales-type leases would be in scope. The timing of profit recognition will be determined by whether control has passed from the seller to the purchaser pursuant to the new *Revenue Recognition* Standard.

- Sale-leaseback transactions – While leases are outside the scope of the new *Revenue Recognition* Standard, accounting for sales would be in scope. Whether or not sales treatment is achieved will impact the ensuing treatment of the lease transaction.

- Collectability – Collectability of rent by the lessor assessed pursuant to the new *Revenue Recognition* Standard will affect the lessors' accounting (We note here in passing that both Type A lease receivables and residual values and Type B lease receivables will be subject to the new impairment guidance under development).

[1] https://www.reit.com/sites/default/files/reitwatch/RW1504.pdf at page 21.

Revenue Recognition – Identifying Performance Obligations and Licenses and *Leases* Projects

An area that continues to be of particular interest is the accounting treatment for tenant reimbursements by lessors. In a situation where a gross lease is negotiated between a landlord and tenant, the lease agreement will specify a single amount that the tenant will pay in rent. This amount will include other items beyond the payment to rent the space, including common area maintenance, taxes, insurance, and perhaps other services. Preparers and auditors alike continue to grapple with whether a portion of the rent payment should be allocated to these other embedded items. In our view, the answer to this question could have a significant impact on the financial statements. For example, this could impact the amount of the lease payables and receivables recognized on the balance sheet, income statement presentation, and footnote disclosure in the lease commitment table.

Revenue Recognition and *Accounting for Sales of Real Estate*

The determination of whether real estate meets the definition of a business under the FASB's *Clarifying the Definition of a Business* Project could have a significant impact on accounting for sales of real estate including, most notably, partial sales of real estate. If real estate does not meet the definition of a business, the accounting treatment of the sale will presumably follow the new *Revenue Recognition* Standard. If real estate meets the definition of a business, the accounting treatment for the sale may ultimately be outside the scope of the *Revenue Recognition* Standard, and be subject to Consolidation guidance. A complicating scenario that has not yet been addressed by the new *Revenue Recognition* Standard is the accounting treatment for partial sales of real estate. With the removal of sections of Accounting Standards Codification (ASC) 360 *Property, Plant, and Equipment* that deals with sales of real estate (formerly FAS 66 *Accounting for Sales of Real Estate*), questions surround how to account for partial sales of real estate.

Transition

Because of the significance of these other Projects and their interrelationship to the *Revenue Recognition* Standard, NAREIT does not support an option to early adopt the *Revenue Recognition* Standard. Further, NAREIT values comparability across the industry to be of utmost importance so that investors and analysts can readily compare the operating performance of NAREIT member companies.

We thank the FASB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 202-739- 9442.

Respectfully submitted,

George L. Yungmann
Senior Vice President, Financial Standards
NAREIT

Christopher T. Drula
Vice President, Financial Standards
NAREIT

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

July 25, 2014

Chairman Russell Golden
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Delivered Electronically

Subject: Lease Accounting Project, Accounting for Initial Direct Leasing Costs

Dear Chairman Golden:

The National Association of Real Estate Investment Trusts (NAREIT®) is submitting this unsolicited comment letter to provide the Financial Accounting Standards Board (FASB) its views on the financial reporting implications of the proposed accounting for initial direct leasing costs on companies that own, operate and lease portfolios of investment property.

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing diversification, dividends, liquidity and transparency to investors through their businesses that operate in all facets of the real estate economy.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. Real Estate Index, which covers both Equity REITs and Mortgage REITs. This Index contained 209 companies representing an equity market capitalization of $804 billion at May 31, 2014. Of these companies, 169 were equity REITs representing 91.2% of total U.S. listed REIT equity market capitalization (amounting to $733 billion)[1]. The remainder, as

[1] http://www.reit.com/sites/default/files/reitwatch/RW1406.pdf at page 21.

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of May 31, 2014, was 40 publicly traded mortgage REITs with a combined equity market capitalization of $71 billion.

Implications of Recent Tentative Decision on "Initial Direct Costs"

At the joint meeting held on May 21, 2014, the Boards tentatively decided that "initial direct costs" should include only incremental costs that an entity would not have incurred if the lease had not been obtained (executed) (for example, commissions or payments made to existing tenants to obtain the lease). These costs could include external and certain internal costs but would not include allocations of internal costs, for example, regular salaries of employees engaged in arranging and negotiating leases.

The decision to allow the capitalization of *only* incremental costs represents a major change from existing U.S. GAAP and, in practice, IFRS. Currently, many companies capitalize all internal direct leasing costs provided that they are able to clearly identify those costs as directly attributable to obtaining successful lease agreements. The costs capitalized are not required to be incremental. Under the proposed accounting, significant internal costs of leasing may not be considered *incremental*. In our view, there is no conceptual basis for, in effect, accounting for direct *internal* leasing costs related to signed leases differently than direct *external* leasing costs.

The implication of no longer permitting the capitalization of a major portion of *direct* costs of internal efforts in securing tenant leases would have a significant detrimental impact on the operating results of NAREIT's member companies and potentially their share prices. This divergence of accounting for direct leasing costs between internal and external costs would clearly result in the lack of comparable operating results between companies having similar substantive leasing efforts despite similarity in economics. In the event that the Board continues in the direction of its May 21 decision, NAREIT is concerned that the proposed accounting standard would create structuring opportunities by encouraging companies to outsource their leasing function to third parties to achieve the most advantageous accounting result. Investors would be harmed if issuers undertake non-economic steps merely to achieve better financial statement results.

The Critical Nature of Leasing Investment Property

Leases generate rental revenue, which is the most important element in generating earnings, cash flow and in the valuation of an investment property. The cash flow from an investment property is the basis on which the property is valued and this property value directly impacts the share price of real estate investment trusts. See Exhibit I *REIT Valuation; The NAV-based Pricing Model* for a full discussion of the relationship between property cash flows (driven primarily by lease revenue), property values and the evaluation of share price.

Generally, a company will develop a leasing plan for each project. These plans identify spaces in each property that are or that will become vacant. With the help of market research, management assigns target rents for each space. Similarly, before making a decision to acquire or develop a property, management will evaluate the market and develop a leasing plan as a critical part of evaluating whether the project's cash flows will generate an adequate economic return.

These leasing plans are typically executed by the internal leasing staff; in some cases supplemented by external leasing resources. Achieving the leasing targets underlies the growth in operating performance of an investment property. Internal leasing staff is generally compensated at a base salary often plus bonuses based on achievement of overall leasing targets. These costs support the same business function as external leasing resources and are generally less costly and more effective than external leasing agents.

The critical nature of leasing in the effort to maximize returns from investment property is evidenced by the significant disclosures made by companies about the impact of leasing on future operating performance. These disclosures are contained in a REIT's Management's Discussion and Analysis, as well as in the company's supplemental reporting materials. See Exhibit II, *Duke Realty Supplemental Information* first quarter 2014, particularly the *Property Information* section, for an illustration of lease and tenant information generally included in a REIT's supplemental materials.

Because of the critical nature of leasing, most of NAREIT's member companies maintain internal leasing staff. They are an integral part of the management team and not simply hired guns with no long-term stake in the company's success. It would be a step backward in reporting the economics of investment property operating performance if the direct costs of this critical internal leasing staff were accounted for differently from the costs of external leasing resources, which, may not be aligned with the company's long-term success.

Further, it would be a very unfortunate result if the proposed accounting forced companies to abandon the most effective leasing structure (internal leasing staff) for a structure external to the management of the company or to dramatically change their compensation arrangements with their leasing staff in order to achieve a desired accounting outcome with limited change in overall economics. There seems to be three possible alternatives for structuring the leasing function under the FASB's most recent decision:

- Maintain current internal structure and expense a significant portion of the cost of internal leasing staff, even when direct efforts result in signed lease agreements;

- Maintain an internal structure but modify the compensation structure to pay staff based on a minimal base salary plus a commission for signed leases (we assume this arrangement would meet the *incremental* criteria for capitalizing leasing costs); or,

- Engage external leasing services, which our industry firmly believes may be less effective and more expensive, and therefore an economic drag on operating results.

NAREIT believes strongly that the proposed Leases standard, which was not intended to change the general model for lessor accounting, should not provide impetus for restructuring a REIT's leasing function to be able to properly capitalize all direct leasing costs.

Current Accounting for Internal Leasing Costs

While practice is mixed in some IFRS jurisdictions, most investment property companies in North America have developed systems to capture the cost of internal leasing effort *directly* related to signed leases. These costs are capitalized and amortized over the term of the related lease in accordance with the guidance in Topic 840 of the U.S. GAAP Accounting Standards Codification (ASC) and, as applied in practice, paragraph 38 of IAS 17, *Leases*.

ASC 840-20-25-18 states "The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that lease and other costs related to those activities that would not have been incurred but for that lease."

IAS 17 paragraph 38 states that "(I)nitial direct costs are often incurred by lessors and include amounts such as commissions, legal fees and internal costs that are incremental and directly attributable to negotiating and arranging a lease."

In Agenda paper 11A of the March 22-23, 2011 meeting of the IASB/FASB, the staff recommendation was "that *initial direct costs* should be defined as: Costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made." It was also noted that "(V)ery little feedback about the definition of initial direct costs was received. The staff thinks that the definition in the ED is appropriate and **consistent with current lease guidance under Topic 840 and IAS 17. The staff notes that the proposed definition is not intended to change current practice for how initial direct costs are defined"** [emphasis added].

Absent the Board overturning its May 21, 2014 decision, it appears that the Boards will change current practice despite the intentions previously expressed by both the Boards and their respective staff. To emphasize, the current accounting practice that reflects the direct relationship between rental revenues and the cost to generate that revenue has been applied for decades and results in the most relevant measurement of operating performance of real estate companies and should be able to be continued.

The Boards' Due Process

NAREIT respectfully, but strongly, objects to the way in which the accounting for initial direct leasing costs was handled in the *Leases* project exposure drafts. The language used in the May 2013 Revised Exposure Draft (the Revised ED) was quite similar to the guidance in Topic 840, particularly when considering the implementation guidance. While Topic 840 did not use the word "incremental" to qualify leasing costs for capitalization, the definition of incremental was similar to the language in Topic 840, which allowed the capitalization of all direct internal costs related to signed leases.

In addition, some constituents were confused based on their view that the definition of initial direct costs in the Revised ED appeared to be inconsistent with the examples provided in the Implementation Guidance.

As a result, NAREIT believes that many constituents concluded that the standard would not change current accounting practice for initial direct leasing costs, and therefore, did not object to this guidance in the Revised ED. It seems as though the Boards have based a major decision on short-circuited constituent input.

IFRIC's Review of this Matter

NAREIT understands that the IFRS Interpretations Committee (IFRIC) discussed this matter in November 2013 and April 2014 and concluded, for a number of reasons, not to add the topic of accounting for *incremental costs* to its agenda. NAREIT is aware of two comment letters that discuss the practice of maintaining internal leasing staff and the basis for capitalizing the costs of all direct internal, as well as external, leasing resources. These letters are attached as Exhibit III (*i.e.*, Real Property Association of Canada (REALpac)) and Exhibit IV (*i.e.*, EY).

NAREIT's Recommendation: Develop a Comprehensive and Consistent Accounting Standard for Costs (both Direct and Indirect).

NAREIT understands that the accounting treatment for costs is an area that varies widely within U.S. GAAP. Costs come in varying types and definitions (*e.g.*, commitment fees, credit card fees and costs, loan syndication fees, loan origination fees and direct loan origination costs, interest costs, insurance acquisition costs, costs of acquiring non-financial assets, etc.) and U.S. GAAP permits capitalization of costs in certain circumstances.

Given the wide diversity of accounting treatment for cost within U.S. GAAP, NAREIT recommends that the FASB forgo further evaluation of accounting for initial direct cost within the *Leases* project. In our view, a robust and comprehensive analysis of cost accounting treatment that would cut across all GAAP literature should be added to the FASB's agenda. We believe that this project would provide a comprehensive cost accounting model and eliminate inconsistencies as a result of dealing with costs on a piece-meal basis in future standard setting.

We offer the following citations as examples of the spectrum of accounting models for capitalizing and expensing costs:

Costs that are Fully Capitalized

The following excerpt is taken from ASC *Property, Plant and Equipment*.

> ASC 360-10-30-1 Paragraph 835-20-05-1 states that the historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use. As indicated in that paragraph, if an asset requires a period of time in which to carry out the activities

> necessary to bring it to that condition and location, **the interest cost incurred during that period as a result of expenditures for the asset is a part of the historical cost of acquiring the asset** [emphasis added].

The following excerpt is taken from the *Financial Instruments – Recognition and Measurement* 2013 Proposal. NAREIT observes that there is no proposed change from current GAAP for loan origination costs. We also note that it appears that the Boards are treating direct finance leases in a different manner when they are economically similar to a loan.

> Direct Loan Origination Costs
>
> Direct loan origination costs represent costs associated with originating a loan. Direct loan origination costs of a completed loan shall include only the following:
>
> a. Incremental direct costs of loan origination incurred in transactions with independent third parties for that loan
>
> b. Certain costs directly related to specified activities performed by the lender for that loan. Those activities include all of the following:
>
>   1. Evaluating the prospective borrower's financial condition
>
>   2. Evaluating and recording guarantees, collateral, and other security arrangements
>
>   3. Negotiating loan terms
>
>   4. Preparing and processing loan documents
>
>   5. Closing the transaction.
>
> The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan. See Section 310-20-55 for examples of items.

The following excerpt is taken from the *Insurance Contracts* Proposal.

> ASC 944-30-25-1 An insurance entity shall capitalize only the following as acquisition costs related directly to the successful acquisition of new or renewal insurance contracts:
>
> a. Incremental direct costs of contract acquisition

b. The portion of the employee’s total compensation (excluding any compensation that is capitalized as incremental direct costs of contract acquisition) and payroll-related fringe benefits related directly to time spent performing any of the following acquisition activities for a contract that actually has been acquired:

1. Underwriting

2. Policy issuance and processing

3. Medical and inspection

4. Sales force contract selling.

c. Other costs related directly to the insurer’s acquisition activities in (b) that would not have been incurred by the insurance entity had the acquisition contract transaction(s) not occurred.

d. Advertising costs that meet the capitalization criteria in paragraph 340-20-25-4.

Costs that are Partially Capitalized

The following excerpt is taken from ASC *Receivables*.

ASC 310-20-25-6 **Bonuses based on successful production of loans that are paid to employees involved in loan origination activities are partially deferrable as direct loan origination costs** under the definition of that term. Bonuses are part of an employee’s total compensation. The portion of the employee’s total compensation that may be deferred as direct loan origination costs is the portion that is directly related to time spent on the activities contemplated in the definition of that term and results in the origination of a loan [emphasis added].

The following excerpts are taken from the recently issued *Revenue from Contracts with Customers* Standard.

ASC 340-40-55-1 Example 1 illustrates the guidance in paragraphs 340-40-25-1 through 25-4 on incremental costs of obtaining a contract, paragraphs 340-40- 25-5 through 25-8 on costs to fulfill a contract, and paragraphs 340-40-35-1 through 35-6 on amortization and impairment of contract costs.

> > > Example 1—Incremental Costs of Obtaining a Contract
340-40-55-2 An entity, a provider of consulting services, wins a competitive bid to provide consulting services to a new customer. The entity incurred the following costs to obtain the contract:

External legal fees for due diligence	$15,000
Travel costs to deliver proposal	25,000
Commissions to sales employees	10,000
Total costs incurred	$50,000

> 340-40-55-3 In accordance with paragraph 340-40-25-1, the entity recognizes an asset for the $10,000 incremental costs of obtaining the contract arising from the commissions to sales employees because the entity expects to recover those costs through future fees for the consulting services. The entity also pays discretionary annual bonuses to sales supervisors based on annual sales targets, overall profitability of the entity, and individual performance evaluations. In accordance with paragraph 340-40-25-1, the entity does not recognize an asset for the bonuses paid to sales supervisors because the bonuses are not incremental to obtaining a contract. The amounts are discretionary and are based on other factors, including the profitability of the entity and the individuals' performance. The bonuses are not directly attributable to identifiable contracts.
>
> 340-40-55-4 The entity observes that the external legal fees and travel costs would have been incurred regardless of whether the contract was obtained. Therefore, in accordance with paragraph 340-40-25-3, those costs are recognized as expenses when incurred, unless they are within the scope of another Topic, in which case, the guidance in that Topic applies.

Costs that are Fully Expensed

The following excerpt is taken from ASC *Business Combinations*.

> ASC 805-10-25-23 Acquisition-related costs are costs the acquirer incurs to effect a business combination. These costs include finder's fees; advisory, legal, accounting, valuation, and other professional and consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. **The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received**, with one exception. The costs to issue debt or equity securities shall be recognized in accordance with other applicable GAAP [emphasis added].

Conclusion

NAREIT objects to the Board's conclusion with respect to initial direct leasing costs, and respectfully requests that the Board reverse the decision in order to preserve current practice. On numerous occasions, the Board has asserted that the intention was not to change current lessor accounting; however, the Board's decision with respect to leasing costs would change the accounting by many lessors of investment property. As we have said in our previous letters to the Boards, we do not believe that current lessor accounting model is broken, and fail to see the reason to create inconsistent accounting results between significant direct internal and external leasing costs that do not reflect the underlying economics of obtaining successful lease agreements.

NAREIT would like to meet with the Board to discuss our views in greater detail. Please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 202-739-9432 to arrange a time for this meeting. If you have questions regarding this letter, please contact George Yungmann or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 202-739-9442.

Respectfully submitted,

George Yungmann
Senior Vice President, Financial Standards
NAREIT

Christopher T. Drula
Vice President, Financial Standards
NAREIT

cc: Chairman Hans Hoogervorst
International Accounting Standards Board

Exhibit I

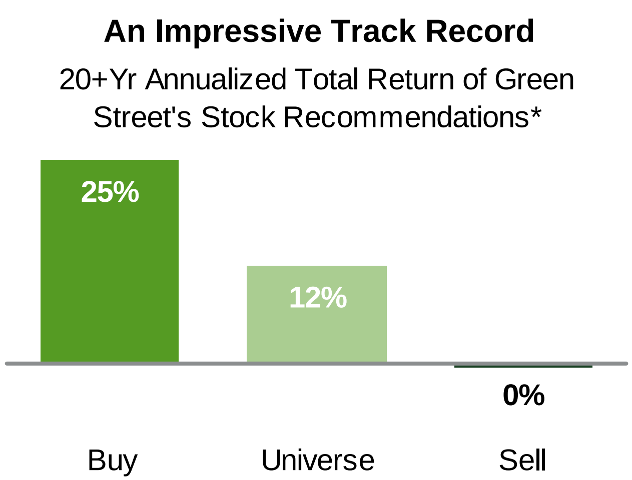
REIT Valuation
The NAV-based Pricing Model

Green Street Advisors

It's All Relative

Our NAV-based Pricing Model has served as the backbone of our stock selection process for over twenty years. The model is designed to assess relative valuations; i.e., it identifies the REITs that are most/least attractively valued.

The model combines NAV – a great starting point and high quality estimates are essential – with the factors that impact the premiums at which REITs should trade: franchise value, balance sheet risk, corporate governance, and overhead. The compartmentalized nature of the model forces discipline to consider all relevant valuation issues.



* Past performance (as of 5/30/14) can not be used to predict future performance. Please see recommendation track record disclosure on page 20

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This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

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Executive Summary

Overview

- Our NAV-based pricing model has been a driver of our stock recomendations for over twenty years
- It has played an instrumental role in our successful recommendation track record
- The compartmentalized nature of the model forces discipline to consider all relevant valuation issues

The Basics

- NAV is the starting point - the value of a REIT is a function of the value of the assets it owns
- Warranted share price = NAV plus or minus a premium for future value added by management
- Franchise value, balance sheet risk, corporate governance and G&A impact the size of the premium
- It is a relative valuation model: roughly equal number of Buys and Sells at all times
- Relative approach anchors around average sector premiums at which REITs trade

The Components

- Franchise values are inherently subjective, but objective inputs help
  - Management Value Added (MVA) shines a bright light on performance attributable to mgm't
  - Total returns relative to peers are also important
  - Balance sheet acumen scores give credit for broad financing menus and low debt costs
- Balance sheets are important; less leverage is better
  - REITs with less leverage have delivered far better returns
  - Investors usually ascribe higher NAV premiums to REITs with low leverage
- Corporate Governance scoring system ranks REITs in a systematic fashion
- The impact of G&A is readily quantified and is dealt with apart from the other factors
  - Differences in G&A are large; they warrant large differences in unlevered asset value premiums

This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

Overview: A Disciplined Approach Toward Stock Selection

A Key Driver of Success: The Green Street NAV-based pricing model is designed to assess the valuation of any REIT relative to sector-level peers. The discipline and rigor the model embodies have played a pivotal role in the two-decade-long success of our recommendation track record. While the model is designed to be neutral with regard to whether REITs in aggregate are cheap or expensive, investors can employ other Green Street analytic tools to help assess overall valuation and/or sector allocation issues.

Company Research

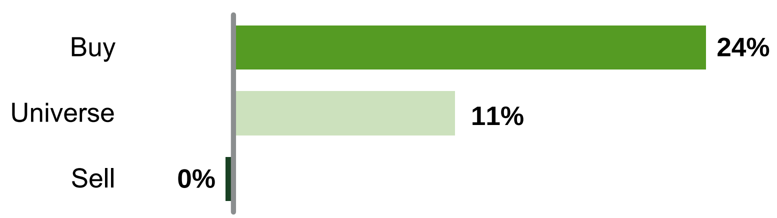
NAV-Based Pricing Model

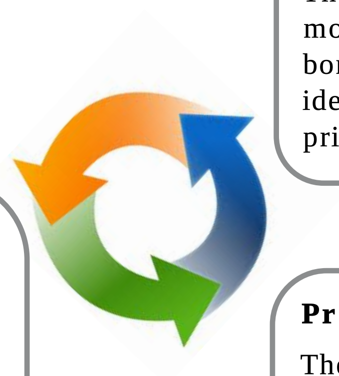
NAV
+ Warranted Premium to NAV
= Warranted Share Price

Stock Recomendations

The NAV-based Pricing Model, coupled with heavy analyst input, drives our stock recommendations. The recommendations are always market and sector neutral.

20+Yr Annualized Returns of Green Street's Recommendations*





Macro Research

Overall REIT Valuation

The ***RMZ Forecast Tool***, published monthly, assesses overall REIT valuation vs. bonds and stocks. Has proven very helpful in identifying periods when REITs are badly mis-priced.

Property Sector Allocation

The ***Commercial Property Outlook***, published quarterly, addresses sector-level valuation questions with a focus on the long term. It is based on extensive research we've published on long-term sector performance and cap-ex requirements.

* Past performance can not be used to predict future performance. Please see recommendation track record disclosure on page 20

Overview: Why Use NAV?

Because We Can: Most equity investors focus a great deal of attention on P/E multiples and/or yields, so it is fair to question why NAV should be the primary valuation benchmark for REITs. The short answer is that investors elsewhere would use NAV if they could, but the concept doesn't translate well to companies that are not in the business of owning hard assets. Because the value of a REIT is, first and foremost, a function of the value of the assets it owns, NAV is a great starting point for a valuation analysis.

Too Simplistic

~~Dividend Yield~~

~~FFO Yield or Multiple~~

~~AFFO Yield or Multiple~~

Far Better

Net Asset Value "NAV"

Good NAV estimates are critical and they require serious resources

Discounted Cash Flow "DCF"

We use DCF internally to double-check results

There is More to it Than Just NAV

Compartmentalized Analysis Looks at Relevant Factors

NAV: The Starting Point

+

The Warranted Premium to NAV

Warranted premiums are a function of:

– Premiums Ascribed by the Market to Other REITs
– Franchise Value
– Balance Sheet Risk
– Corporate Governance
– Overhead (G&A expenses)

Warranted Share Price

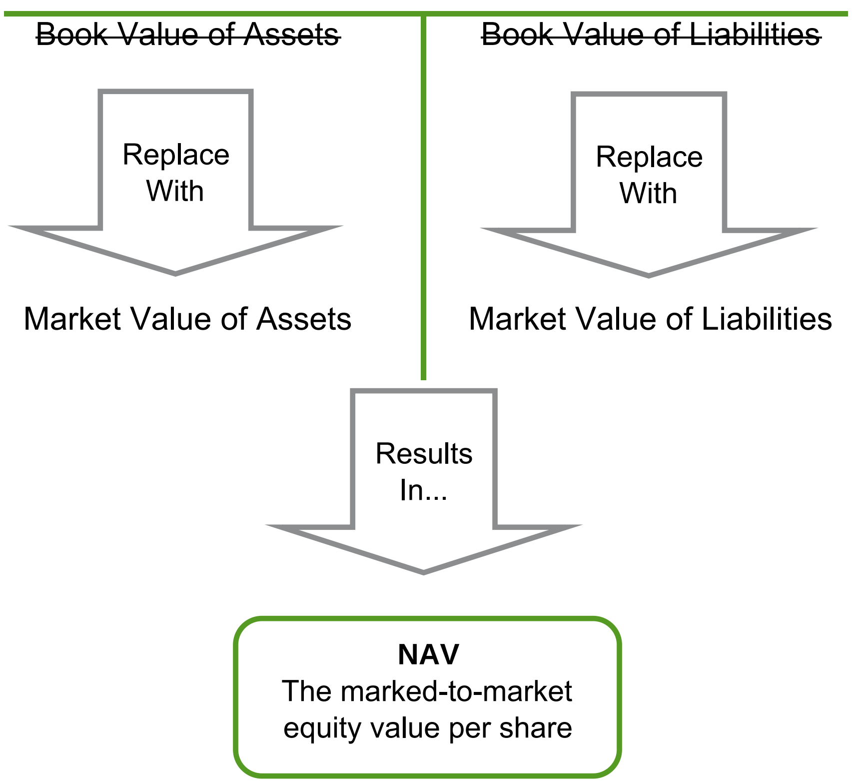
Used to compare valuations *relative* to those of other REITs. It's fair to call it "relative intrinsic value."

This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

Overview: What is NAV?

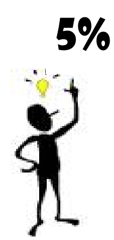
Mark It to Market: An NAV-based valuation methodology is only as good as the underlying estimate of NAV. High-quality estimates of marked-to-market asset value require a great deal of effort and resources, but the estimate can be reasonably precise when done properly. It is also important to mark-to-market the right-hand side of the balance sheet, as the cost of in-place debt can stray substantially from prevailing market. Many market participants skip this important step.

REIT Balance Sheet



Common Question: *Many REIT investors and analysts do not mark debt to market. Is it really necessary?*

Imagine: Two identical office buildings, except that one is encumbered by a 60% LTV mortgage carrying a 7% interest rate with another five years to run, while the other has an identical loan at a 5% rate. Which building will command the higher price?



The answer is obvious to any real estate market practitioner. Building prices are profoundly impacted by assumed debt, and a high-cost mortgage negatively impacts pricing. The same holds true when those buildings are held by a REIT and if the debt is unsecured rather than secured. Marking assets to market without doing the same for liabilities yields the wrong answer.

This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

Overview: NAV - A Simplified Example

Calculating NAV - A Simplified Example

Balance Sheet for REIT XYZ (X's $1,000)

	Book Value	***Analyze Market Value and Replace***	***Current Value***
Real Estate Assets			
Operating Real Estate	$6,000,000	A	$9,350,000
			$2,250,000
Construction in Progress	$500,000	B	$550,000
Land	$200,000	C	$162,000
		D	
Equity in Unconsolidated JVs	$1,000,000		$0
		D	
Value of Fee Businesses	$0	E	$500,000
Other Assets	$100,000	F	$68,625
Total Assets	$7,800,000		$12,880,625
Liabilities	$5,000,000	G	$5,250,000
			$1,500,000
Preferred Stock	$500,000		$500,000
Shareholders Equity	$2,300,000		$5,630,625
Fully Diluted Shares	200,000	H	204,750
NAV	$11.50		$27.50

The Adjustments:

A. Operating Real Estate: The most important part of an NAV analysis, this step invloves calculating a 12-month forward estimate of NOI and applying an appropriate cap rate. The quality of the analysis rests on an in-depth knowledge of prevailing cap rates, the quality/location of the real estate, and other required industry- and company-specific adjustments.

B. Construction in Progress: Adjustments to the book value of CIP reflect the extent to which stabilized yields are likely to exceed an appropriately high risk-adjusted return bogey.

C. Land: Land values can be much higher or lower than book.

D. Joint Venture Accounting is a Mess: Because of that, we present a pro-rata allocation of JV assets and liabilities. There is no reliable way to otherwise value JV interests, as leverage within the JV typically renders more simplified approaches useless. A pro-rata allocation also does a much better job of showing leverage that may be embedded, but otherwise hidden, in JV investments.

E. Fee Income: Some REITs generate asset management/property management fees associated with JV structures. This fee income can be lucrative, and the range of appropriate multiples to apply is dependent on the quality of the fee stream. This value is not reflected on GAAP balance sheets.

F. Other Assets: REITs often have a material amount of intangible assets, which are deducted for this exercise.

G. Liabilities: Mark-to-market adjustments are necessary where: subsidized financing is present, or market interest rates are materially higher or lower than contract rates on the REIT's debt.

H. Fully Diluted Shares: All in-the-money options, converts, etc. need to be included in the share count.

Overview: NAV - More on Operating Real Estate

Calculating NAV - More on Operating Real Estate

Income Statement for REIT XYZ (X's $1,000)

Three Months Ending XXX	
GAAP Net Operating Income (NOI)	$149,500
Adjustments	
Straight-Line Rent (A)	($1,250)
NOI of Properties Acquired During Quarter (B)	$1,750
Quarterly Pace of Net Operating Income	$150,000
Annual Pace NOI	$600,000
Estimated Growth Over Next 12 Months	$12,000
12-Month Look-Forward NOI Estimate	$612,000
Cap Rate (C)	6.5%
Value of Operating Real Estate	$9,350,000

The Adjustments:

A. **Straight-Line Rent:** GAAP requires that companies report average rental revenue over the term of the lease. For example, GAAP rent for a 10-yr lease with a starting rent of $50/sqft and 2% annual escalators is $55/sqft. Phantom income items like straight-line rent need to be deducted to arrive at "cash" NOI.

B. **Acquisitions:** Properties acquired during the quarter will contribute less to reported NOI than they would have had they been owned the full period. Reported NOI needs to be adjusted upward when this is the case.

C. **Cap Rate:** The convention in the real estate industry is to quote pricing in terms of the first-year yield on investment. This measure is known as the capitalization rate (cap rate). Cap rates are the most critical input in the NAV analysis. An in-depth understanding of the location, age, and general desirability of the real estate portfolio coupled with a good handle on prevailing cap rates is essential to coming up with good estimates. The cap rate for the entire porttfolio is shown here, but the analysis is typically done on a market-by-market basis.

Overview: Where Do Green Street NAVs Come From?

Hard Work: Green Street takes its NAVs very seriously. We devote a great deal of resources toward deriving the best possible estimates of NAV because it has always been the driver of our valuation conclusions.

Kicking the Tires

Extensive property visits
Deep market contacts - public & private
Lengthy coverage of most REITs
Strategic partner: Eastdil Secured

A Large Research Team

25 full-time research professionals in US
We take NAV seriously
It has always driven our Pricing Model

Real Estate Data Sources

Green Street's property databases are extensive
We also use other research vendors
Local leasing and sales brokers

Cap-ex: the 500-Pound Gorilla

Capitalized costs are big and they need to be considered
They vary a lot even among REITs in the same sector
Cap-ex is broadly misunderstood…we have studied extensively
Market participants underestimate cap-ex
Cap-ex policies influence the cap rate used

Overview: Warranted Premiums to NAV

NAV Plus or Minus? Prospective future total returns for any REIT are a function of how its real estate portfolio is likely to perform, as well as the value that its management team is likely to add or detract. Our Pricing Model provides a systematic assessment of the four key variables - franchise value, corporate governance, balance sheet risk, and overhead - that typically distinguish REITs that deliver "real estate plus" returns from those in the "real estate minus" camp.

Warranted Premium to NAV for a REIT is a Function of...

Prevailing Premiums for Sector Peers Based on Prevailing Share Prices

The *net* value that a management team is likely to add or detract in the future

Our Pricing Model tallies up a total score on the variables below and ranks each REIT relative to sector peers

Franchise Value
A gauge of management's propensity to add or detract value

Corporate Governance
Our governance scoring system provides an annual review

Balance Sheet Risk
Capital Structure plays a big role in how REITs are valued

Capitalized Value of Unusual G&A
This can be readily quantified and is dealt with apart from the other factors that impact premiums

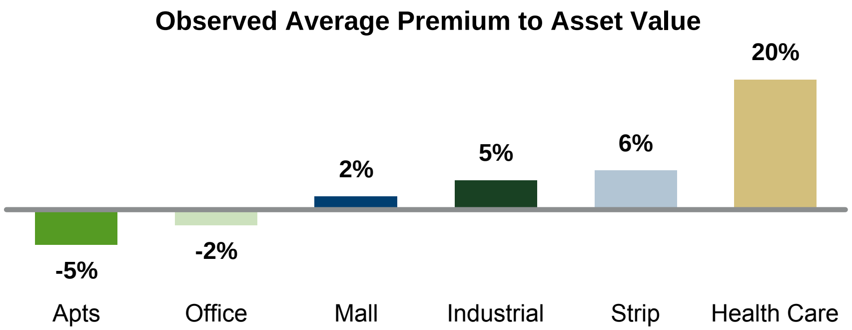
Which is it, NAV or UAV?

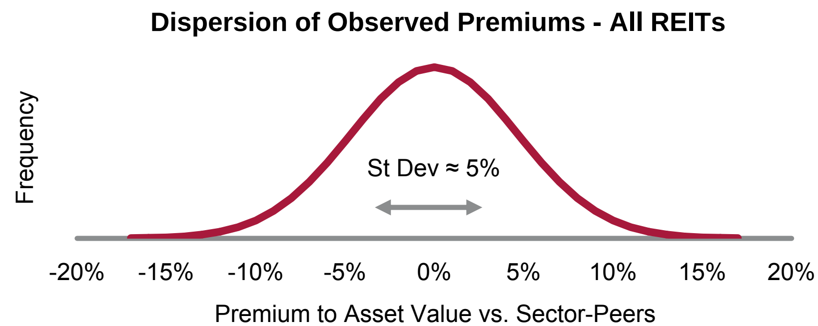
The investment world focuses on premiums to **NAV**, which are impacted by leverage, but the mechanics of our model strip out the distortions leverage can cause by focusing on premiums to **unlevered asset value (UAV)**. Even though the model is UAV-centric, the many references herein to NAV are employed to better speak the language most commonly used in our industry.

Overview: The Influence of Property Sectors

A Normal World: The starting point in calculating the warranted premium for any REIT is the sector-average premium ascribed by the market at current share prices. An assumption is made that the dispersion of observed premiums for the entirety of our coverage universe serves as a good indicator of how premiums should be dispersed in any given sector. REITs that stack up better in the Pricing Model relative to their sector peers are then ascribed better-than-average warranted premiums, and vice versa.

Each sector tends to march to its own drummer on average premiums... ...to which the dispersion of premiums for all REITs can be applied



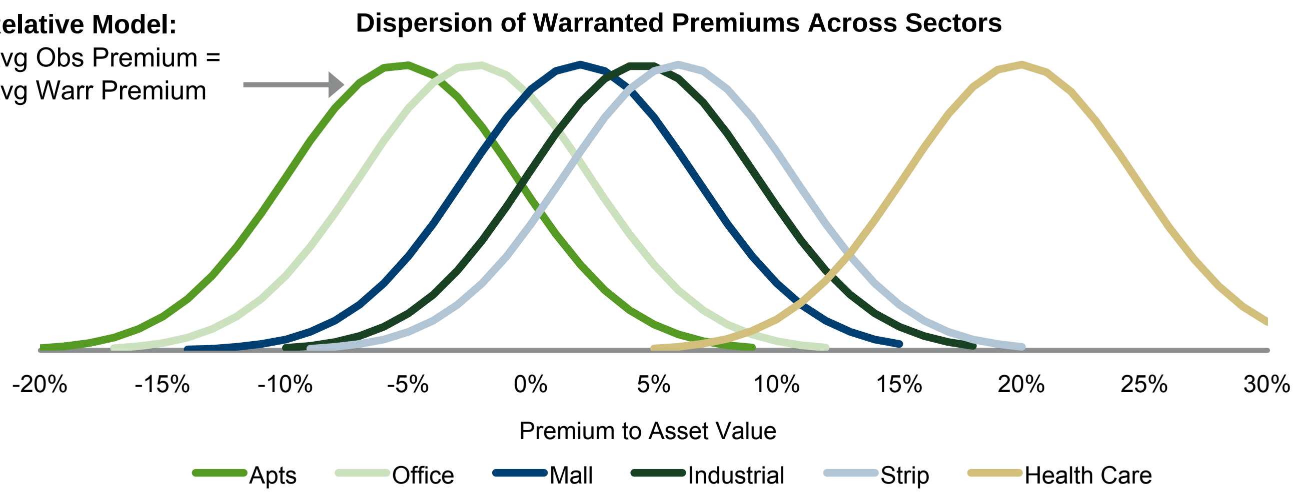


Why Sector Premiums Vary

There are three primary reasons:
1) REIT investors often disagree with private-market valuations
2) Some sectors may offer more lucrative growth opportunities.
3) A sector full of "A-students" should trade better

The model is neutral with regard to sector valuations.

Relative Model:
Avg Obs Premium =
Avg Warr Premium



Franchise Value: What is it?

An Important Assessment: Franchise value and G&A are the most important drivers of UAV premiums. Franchise value pertains to the value that a management team is likely to create in the future, which is a question best addressed by combining objective tools with subjective input from experienced analysts.

Franchise Value: a Forward-Looking Concept

Franchise value is an estimate of the relative value that a management team is likely to add or detract in coming years. Our analysts determine franchise value based on a wide variety of objective inputs and subjective assessments.

Subjective Factors

Lessons from REIT History

Simplicity is a virtue

Activity ≠ Value Added

Development is a tough business

Capital allocation skills are critical

Other Factors to Consider

Will past performance recur?

Has there been a strategy change?

Has management learned lessons?

Objective Metrics

Past Performance	Balance Sheet Management
Management Value Added (MVA)	Balance Sheet Acumen Score
Total Returns to Shareholders	Full Menu of Options is good
	Cheap debt → UAV Premium

Franchise Score

The objective metrics help guide the analyst, but the ultimate score is entirely at his/her discretion.

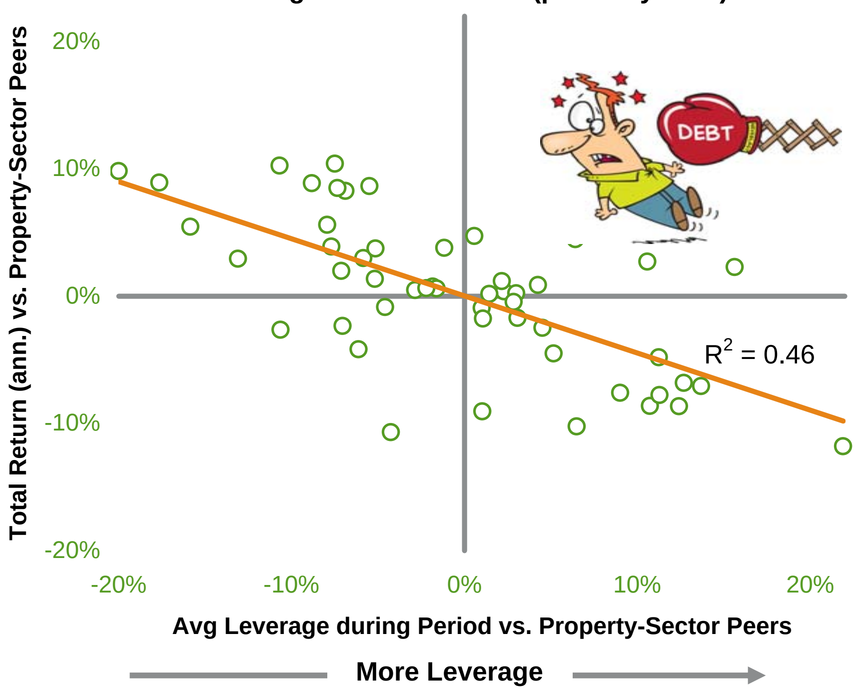
Balance Sheet Risk: Balance Sheets Matter

Low Leverage is Better: Even though property prices have risen more than 50% over the last ten years, REITs that have employed less leverage have delivered far better returns over that time period than REITs with higher leverage. The same statement has held true over the vast majority of ten-year periods since the Modern REIT era commenced in the early-'90s. Not surprisingly, investors are willing to ascribe much higher NAV premiums to REITs with low leverage.

Leverage has Impacted Total Returns

A 10% variance in the lev'g ratio has been associated with a 5% gap in total returns. Every year!

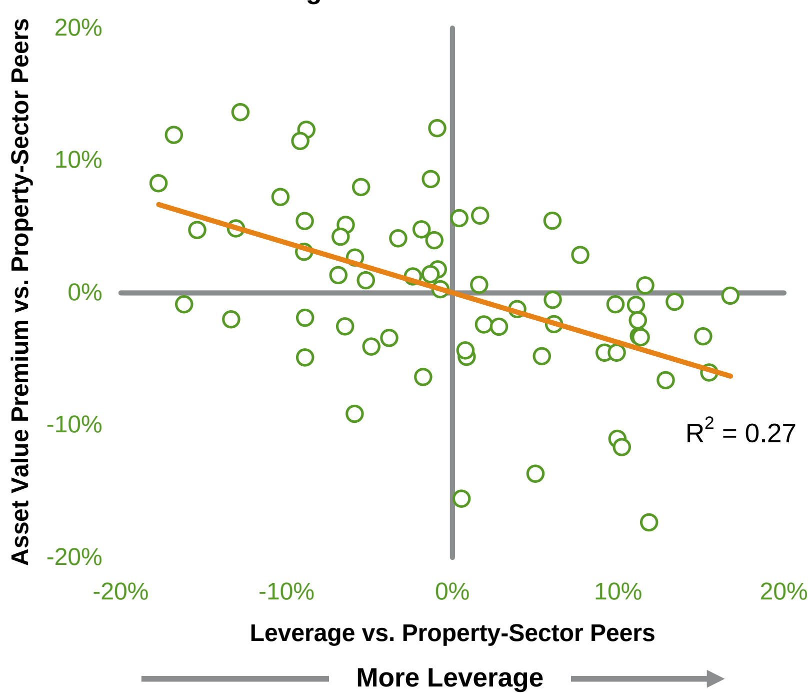
Leverage & Total Returns (past 10 years*)



Leverage has a Big Impact on Pricing

A 10% variance in the lev'g ratio currently equates to a 4% variance in the UAV premiums at which REITs trade

Leverage & Premiums to Asset Value*



* Charts are from Oct 2, 2012 Heard on the Beach. Left chart uses total returns from Aug '02 to Aug '12; right is based on stock pricing as of Sept '12.

Corporate Governance

Green Street's Governance Scoring System: Our governance ranking system, which is published annually, differs in two key respects from those provided by other evaluators: 1) our familiarity with the companies allows for subjective input; and 2) issues unique to REITs (e.g., the 5 or fewer rule) are ignored by others. Scoring is on a 100-point basis with the key inputs highlighted below. REITs with higher governance scores typically trade at larger premiums to asset value.

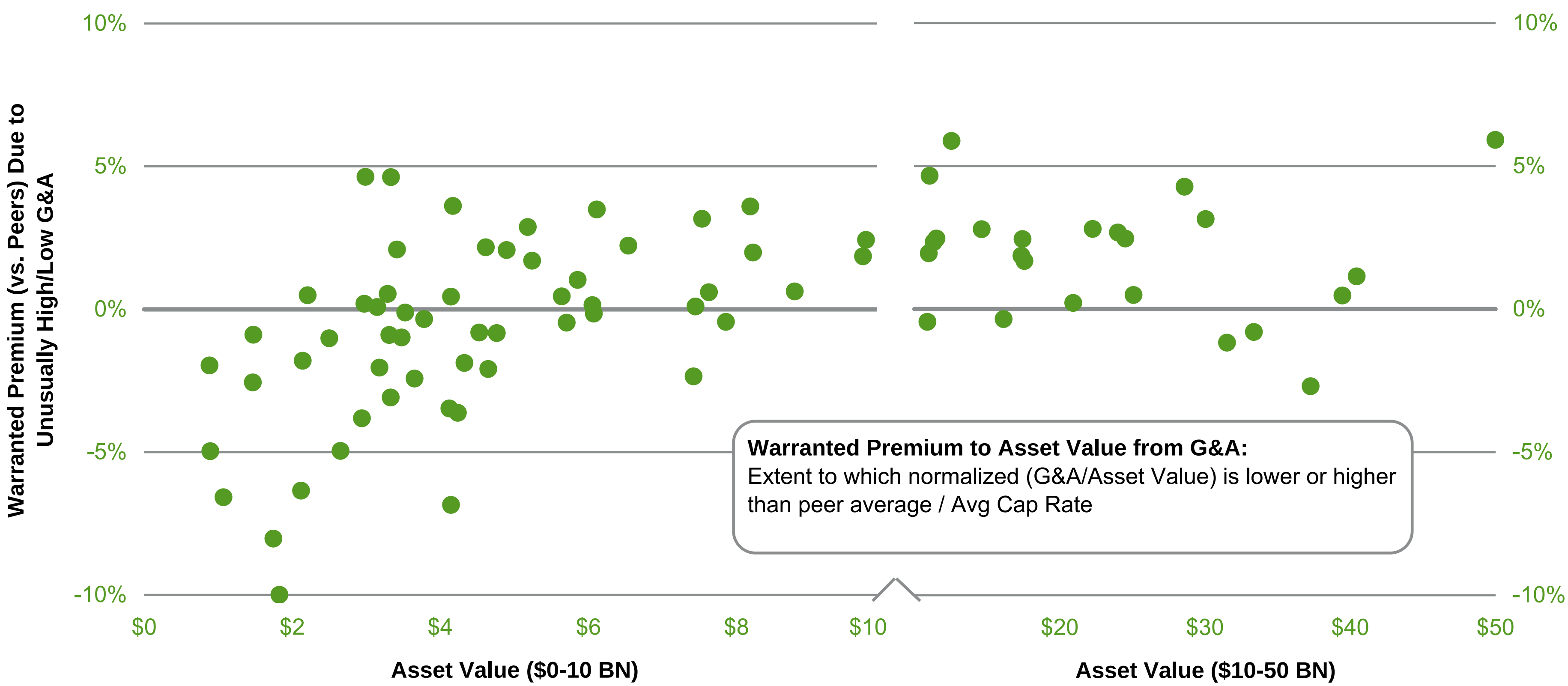
Category	Max Points	Ideal Structure
Board Rating:		
Non-staggered Board	20	Yes
Independent Board	5	80+%
Investment by Board Members	5	Large Investment by Numerous Members
Conduct	25	No Blemishes, Fair Comp, Leadership
Total	**55**	
Anti-Takeover Weapons:		
State Anti-takeover Provisions	12	Opt out/Shareholders Approve Change
Ownership Limits from 5/50 Rule	5	Limit Waived for Ownership by other REITs
Shareholder Rights Plan	10	Shareholders Must Approve Implementation
Insider Blocking Power	8	No Veto Power
Total	**35**	
Potential Conflicts of Interest:		
Business Dealings with Mgmt.	6	No Business Dealings
Divergent Tax Basis of Insiders	4	Basis Near Share Price
Total	**10**	
Perfect Score	**100**	

Anti-Takeover Weapons
There are only a handful of REITs where insiders hold a blocking position, but it's a big deal where it exists. Because of that, a cap is placed on how many points a REIT where blocking power is present can score on anti-takeover rankings. After all, the anti-takeover provisions don't matter much if insiders control the vote.

Overhead: A Strong Connection with Size

Big is Better: A dollar of cash flow devoted to G&A is worth the same as a dollar of cash flow at the property level, and efficiency differences between REITs can have a profound impact on share valuation. The impact on appropriate unlevered valuations can be calculated by capping those differences at the all-REIT cap rate and adding or subtracing that figure directly as a warranted premium to unlevered asset value. Not surprisingly, big REITs are more efficient when it comes to overhead, and this efficiency should translate into higher relative valuations.

Company Size and Warranted Premiums Attributable to G&A



This report is an excerpt from REIT Valuation: Version 3.0 of our Pricing Model

Frequently Asked Questions

Answers to Frequently Asked Questions

Q. Net Asset Value (NAV) estimates are far from precise. It's very common to see NAV estimates for a given REIT spanning a broad range, with some being as much as 30% higher than others. Why base a model on such an imprecise estimate?

A. NAV is admittedly an imprecise estimate of value. It may be best to consider NAV as the midpoint of a reasonable range in which a figure at least 5% higher or lower than the midpoint might be accurate. Reasonable minds can disagree within this range. However, this lack of precision should not be viewed as a serious shortcoming. Every valuation methodology lacks precision, and alternative methodologies are almost certainly less precise than NAV. For instance, where do appropriate Price/Earnings (P/E) multiples come from? EBITDA multiples? An NAV-based approach componentizes the valuation question into discrete pieces and incorporates private-market pricing information, attributes that should yield a higher level of precision than a broad-brush approach to entity valuation. When analyst estimates of NAV fall well outside a reasonable range, this probably reflects the quality of the analysis, as opposed to the metric's quality. In addition, most analysts only mark-to-market the left-hand side of the balance sheet; Green Street marks-to-market the right-hand side too. NAV calculations require a great deal of time, energy, and expertise to get right; big errors likely occur when shortcuts are taken.

Q. An NAV analysis is only as good as the cap rate applied to net operating income (NOI). Where does Green Street get its cap rates?

A. The choice of cap rates is the most important input in our model. Our analysts spend a great deal of time talking to market participants (e.g., REIT executives, private real estate participants, brokers, etc.), compiling databases of comparable transactions, reading trade publications, reviewing findings of providers of transaction information, and understanding the extent to which contractual rents are above or below market.

Q. As the REIT industry continues to mature, analysts and investors will inevitably value these stocks the same way the vast majority of other stocks are valued. Approaches based on P/E multiples, EBITDA multiples, or discounted cash flow models will take the place of a REIT-centric concept like NAV. After all, no one tries to figure out the NAV of General Motors or Microsoft, so why bother to do so with REITs?

A. The simple answer to this question is that investors in other sectors would use NAV if they could. However, their inability to do so relegates them to using generally inferior metrics. Thoughtfully applied alternative approaches to valuation should result in similar answers to an NAV-based approach, but these other methods must be used with caution.

Frequently Asked Questions (continued)

Q. REITs are more than just a collection of assets. Management matters a lot, and an NAV-based approach can't possibly factor that in.

A. Contrary to a widespread misperception, the use of an NAV-based model is consistent with a view that management is important. As long as an NAV-based model provides output with a sizable variance in company-specific warranted premiums/discounts, that model is implicitly acknowledging that management matters significantly. Capital allocation and balance sheet management are by far the key differentiators of management capabilities.

Q. Many REITs own hundreds of properties spread across the U.S., and an asset-by-asset appraisal would take an enormous amount of time. How can an analyst know the value of any given portfolio?

A. A reasonable NAV estimate can be derived if disclosure at the portfolio level is sufficient to allow for a comparison of the characteristics of a given portfolio with the characteristics of properties that have traded hands. No two portfolios are exactly the same, but plenty of pricing benchmarks exist to allow for adjustments based on portfolio location, quality, lease structure, growth prospects, etc.

Q. REITs have broad latitude in how they expense many operating costs. Can an NAV-based approach be fooled if a REIT inflates NOI by moving costs to the General & Administrative (G&A) expense line?

A. Yes. This is why an explicit valuation adjustment for G&A expense is included in our pricing model. It identifies companies that shift expenses in ways that are inconsistent with those of its peers.

Q. An NAV analysis derived from real estate NOI seemingly ignores capital expenditures (cap-ex). How does cap-ex factor into the analysis?

A. One of the easiest ways to make big mistakes in an NAV analysis is to utilize simple rules of thumb with regard to cap-ex. Most rules of thumb undercount the magnitude of cap-ex. In addition, the range of appropriate reserves varies hugely by property sector, property quality, and accounting practices. Each factor needs to be addressed before choosing the cap-ex reserve to utilize for a particular portfolio. The real estate portfolios in any sector that offer the highest quality, best growth, and lowest risk should be accorded the highest valuation multiples (lowest cap rates), and vice versa. Thus, it is important to rank the portfolios relative to each other and to then ensure "economic" cap rates (based on NOI less a cap-ex reserve) line up in this manner. An analysis that does not back out cap-ex costs, and is instead based off of nominal cap rates, will generate misleading relative conclusions.

Frequently Asked Questions (continued)

Q. NAV is a backward looking metric.

A. Real estate markets are active and liquid, and when buyers and sellers agree on deal terms (e.g., cap rates, price/square foot, etc.), those terms reflect their views of future prospects. When prevailing cap rates are applied to a REIT's forward-looking NOI estimate, the result is an estimate of value that is as forward looking as any other approach toward valuing stocks.

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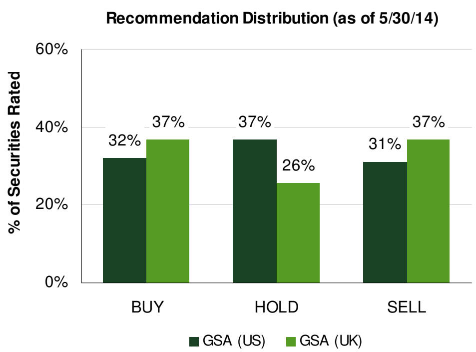
- Green Street will furnish upon request available investment information supporting the recommendation(s) contained in this report.

At any given time, Green Street publishes roughly the same number of “BUY” recommendations that it does “SELL” recommendations.



Green Street’s “BUYs” have historically achieved far higher total returns than its ”HOLDs”, which, in turn, have outperformed its “SELLs”.

Year	Buy	Hold	Sell	Universe[3]
2014 YTD	17 7%	14 6%	10 8%	14 4%
2013	4 1%	0 6%	1 7%	2 2%
2012	24 5%	24 7%	18 9%	23 0%
2011	18 9%	7 6%	4 7%	7 6%
2010	43 3%	32 8%	26 6%	33 8%
2009	59 0%	47 7%	6 0%	37 9%
2008	28 1%	30 9%	52 6%	37 3%
2007	6 9%	22 4%	27 8%	19 7%
2006	45 8%	29 6%	19 5%	31 6%
2005	26 3%	18 5%	1 8%	15 9%
2004	42 8%	28 7%	16 4%	29 4%
2003	43 3%	37 4%	21 8%	34 8%
2002	17 3%	2 8%	2 6%	5 4%
2001	34 9%	19 1%	13 0%	21 1%
2000	53 4%	28 9%	5 9%	29 6%
1999	12 3%	9 0%	20 5%	6 9%
1998	1 6%	15 1%	15 5%	12 1%
1997	36 7%	14 8%	7 2%	18 3%
1996	47 6%	30 7%	18 9%	32 1%
1995	22 9%	13 9%	0 5%	13 5%
1994	20 8%	0 8%	8 7%	3 1%
1993	27 3%	4 7%	8 1%	12 1%
Cumulative Total Return	**10566 3%**	**856 2%**	**1 8%**	**961 4%**
Annualized	**24 5%**	**11 2%**	**0 1%**	**11 7%**

The results shown in the table in the upper right corner are hypothetical; they do not represent the actual trading of securities. Actual performance will vary from this hypothetical performance due to, but not limited to 1) advisory fees and other expenses that one would pay; 2) transaction costs; 3) the inability to execute trades at the last published price (the hypothetical returns assume execution at the last closing price); 4) the inability to maintain an equally-weighted portfolio in size (the hypothetical returns assume an equal weighting); and 5) market and economic factors will almost certainly cause one to invest differently than projected by the model that simulated the above returns. All returns include the reinvestment of dividends. Past performance, particularly hypothetical performance, can not be used to predict future performance.

(1) Results are for recommendations made by Green Street’s North American Research Team only (includes securities in the US, Canada, and Australia). Uses recommendations given in Green Street's "Real Estate Securities Monthly" from January 28, 1993 through May 23, 2014. Historical results from January 28, 1993 through October 1, 2013 were independently verified by an international "Big 4" accounting firm. The accounting firm did not verify the stated results subsequent to October 1, 2013. As of October 1, 2013, the annualized total return of Green Street’s recommendations since January 28, 1993 was: Buy +24.5%, Hold +10.9%, Sell -0.3%, Universe +11.5%.

(2) Company inclusion in the calculation of total return has been based on whether the companies were listed in the primary exhibit of Green Street’s "Real Estate Securities Monthly”. Beginning April 28, 2000, Gaming C-Corps and Hotel C-Corps, with the exception of Starwood Hotels and Homestead Village, were no longer included in the primary exhibit and therefore no longer included in the calculation of total return. Beginning March 3, 2003, the remaining Hotel companies were excluded.

(3) All securities covered by Green Street with a published rating that were included in the calculation of total return. Excludes “not rated” securities.

Per NASD rule 2711, “Buy” = Most attractively valued stocks. We recommend overweight position; “Hold” = Fairly valued stocks. We recommend market-weighting; “Sell” = Least attractively valued stocks. We recommend underweight position.

Green Street will furnish upon request available investment information regarding the recommendation

Exhibit II

SUPPLEMENTAL INFORMATION

FIRST QUARTER 2014

Duke REALTY

RELIABLE. ANSWERS.

Exhibit II

Duke REALTY

Table of Contents

Duke Realty Corporation 600 East 96th Street, Suite 100 Indianapolis, IN 46240 317-808-6005 FAX 317-808-6770

When used in this supplemental information package and the conference call to be held in connection herewith, the word “believes,” “expects,” “estimates” and similar expressions are intended to identify forward-looking statements. Such statements are subject to certain risks and uncertainties which could cause actual results to differ materially. In particular, among the factors that could cause actual results to differ materially are continued qualification as a real estate investment trust, general business and economic conditions, competition, increases in real estate construction costs, interest rates, accessibility of debt and equity capital markets and other risks inherent in the real estate business including tenant defaults, potential liability relating to environmental matters and liquidity of real estate investments. Readers are advised to refer to Duke Realty's Form 10-K Report as filed with the Securities and Exchange Commission on February 21, 2014 for additional information concerning these risks.

Duke Realty Corporation

About Duke Realty

Duke Realty Corporation ("Duke Realty") specializes in the ownership, management and development of bulk industrial, suburban office and medical office real estate. Duke Realty is the largest publicly traded, vertically integrated office/industrial/medical office real estate company in the United States. The company owns, maintains an interest in or has under development approximately 154.1 million rentable square feet in 22 major U.S. metropolitan areas. Duke Realty is publicly traded on the NYSE under the symbol DRE and is listed on the S&P MidCap 400 Index.

Duke Realty's Mission Statement

Our mission is to build, own, lease and manage industrial, office and healthcare properties with a focus on customer satisfaction while maximizing shareholder value.

Structure of the Company

Duke Realty has elected to be taxed as a Real Estate Investment Trust (REIT) under the Internal Revenue Code. To qualify as a REIT, we must meet a number of organizational and operational requirements, including a requirement to distribute at least 90% of our adjusted taxable income to our shareholders. Management intends to continue to adhere to these requirements and to maintain our REIT status. As a REIT, we are entitled to a tax deduction for some or all of the dividends we pay to shareholders. Accordingly, we generally will not be subject to federal income taxes as long as we distribute an amount equal to or in excess of our taxable income to shareholders. We are also generally subject to federal income taxes on any taxable income that is not distributed to our shareholders. Our property operations are conducted through a partnership in which Duke Realty is the sole general partner owning a 99 percent interest at March 31, 2014. This structure is commonly referred to as an "UPREIT." The limited partnership ownership interests in this partnership (referred to as Units) are exchangeable for shares of common stock of Duke Realty. Duke Realty is also the sole general partner in another partnership which conducts our service operations.

Product Review

Bulk Distribution Industrial Properties: Duke Realty owns interests in 503 bulk distribution industrial properties encompassing more than 127.8 million square feet (83 percent of total square feet). These properties are primarily warehouse facilities with clear ceiling heights of 28 feet or more. This also includes 37 light industrial buildings, also known as flex buildings, totaling 2.3 million square feet.

Suburban Office Properties: Duke Realty owns interests in 167 suburban office buildings totaling more than 19.6 million square feet (12 percent of total square feet).

Medical Office Properties: Duke Realty owns interests in 72 medical office buildings totaling more than 5.7 million square feet (4 percent of total square feet).

Retail Properties: Duke Realty owns interests in 5 retail buildings encompassing more than 936,000 square feet (1 percent of total square feet).

Land: Duke Realty owns or controls through options or joint ventures more than 5,600 acres of land located primarily in its existing business parks. The land is ready for immediate use and is primarily unencumbered by debt. More than 86 million square feet of additional space can be developed on these sites and all of the land is fully entitled for either office, industrial, or medical office.

Service Operations: As a fully integrated company, Duke Realty provides property and asset management, development, leasing and construction services to third party owners in addition to its own properties. Our current property management base for third parties includes more than 4.3 million square feet.

Investor Information

Research Coverage

Bank of America/Merrill Lynch	Jamie Feldman	212.449.6339
Barclays	Ross Smotrich	212.526.2306
BMO Capital Markets	Paul Adornato	212.885.4170
Citi	Kevin Varin	212.816.6243
Cowen and Company	James Sullivan	646.562.1380
Edward Jones & Co.	Ashtyn Evans	314.515.2751
Green Street Advisors	Eric Frankel	949.640.8780
J.P. Morgan	Tony Paolone	212.622.6682
Morgan Stanley	Vance Edelson	212.761.0078
RBC Capital Markets	Mike Salinsky	440.715.2648
R.W. Baird	Dave Rodgers	216.737.7341
S&P Capital IQ	Erik Oja	212.438.4314
SunTrust Robinson Humphrey	Ki Bin Kim	212.303.4124
Stifel Nicolaus & Co	John Guinee	443.224.1307
UBS	Ross Nussbaum	212.713.2484
Wells Fargo Securities	Brendan Maiorana	443.263.6516

Timing

Quarterly results will be announced according to the following approximate schedule:

First Quarter	Late April
Second Quarter	Late July
Third Quarter	Late October
Fourth Quarter and Year-End	Late January

Duke will typically publish other materials of interest to investors according to the following schedule:

Report	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Due Date
Form 10Q	May	August	November		
Supplemental Materials	Late April	Late July	Late October	Late January	
Annual Report					March
Proxy Statement					March
Form 10-K					March
News Releases					As Appropriate

The above information is available on Duke Realty's web site at http://www.dukerealty.com

Stock Information

Duke Realty’s common stock is traded on the New York Stock Exchange (symbol: DRE).
Duke Realty’s Series J preferred stock is traded on the New York Stock Exchange (symbol: DRE PRJ).
Duke Realty’s Series K preferred stock is traded on the New York Stock Exchange (symbol: DRE PRK).
Duke Realty’s Series L preferred stock is traded on the New York Stock Exchange (symbol: DRE PRL).

Senior Unsecured Debt Ratings:

Standard & Poor's	BBB
Moody's	Baa2

Inquiries

Duke Realty welcomes inquiries from stockholders, financial analysts, other professional investors, representatives of the news media and others wishing to discuss the company. Please address inquiries to, Investor Relations, at the address listed on the cover of this guide. Investors, analysts and reporters wishing to speak directly with our operating officers are encouraged to first contact the Investor Relations department. Interviews will be arranged as schedules permit.

Common Stock Data (NYSE:DRE):

	1st Quarter 2013	2nd Quarter 2013	3rd Quarter 2013	4th Quarter 2013	1st Quarter 2014
High price*	17.16	18.80	17.56	17.23	17.03
Low price*	13.94	14.29	14.12	14.18	14.48
Closing price*	16.98	15.59	15.44	15.04	16.88
Dividends paid per share	.170	.170	.170	.170	.170
Closing dividend yield	4.0%	4.4%	4.4%	4.5%	4.0%

Exhibit II

FFO and AFFO Reporting Definitions

Funds from Operations ("FFO"): FFO is computed in accordance with standards established by the National Association of Real Estate Investment Trusts ("NAREIT"). NAREIT defines FFO as net income (loss) excluding gains (losses) on sales of depreciable property, impairment charges related to depreciable real estate assets, and extraordinary items (computed in accordance with generally accepted accounting principles ("GAAP")); plus real estate related depreciation and amortization, and after similar adjustments for unconsolidated joint ventures. We believe FFO to be most directly comparable to net income as defined by GAAP. We believe that FFO should be examined in conjunction with net income (as defined by GAAP) as presented in the financial statements accompanying this release. FFO does not represent a measure of liquidity, nor is it indicative of funds available for our cash needs, including our ability to make cash distributions to shareholders.

Core Funds from Operations ("Core FFO"): Core FFO is computed as FFO adjusted for certain items that are generally non-cash in nature and that materially distort the comparative measurement of company performance over time. The adjustments include gains on sale of undeveloped land, impairment charges not related to depreciable real estate assets, tax expenses or benefit related to (i) changes in deferred tax asset valuation allowances, (ii) changes in tax exposure accruals that were established as the result of the previous adoption of new accounting principles, or (iii) taxable income (loss) related to other items excluded from FFO or Core FFO (collectively referred to as "other income tax items"), gains (losses) on debt transactions, adjustments on the repurchase or redemption of preferred stock, gains (losses) on and related costs of acquisitions, and severance charges related to major overhead restructuring activities. Although our calculation of Core FFO differs from NAREIT's definition of FFO and may not be comparable to that of other REITs and real estate companies, we believe it provides a meaningful supplemental measure of our operating performance.

Adjusted Funds from Operations ("AFFO"): AFFO is defined by the company as Core FFO (as defined above), less recurring building improvements and total second generation capital expenditures (the leasing of vacant space that had previously been under lease by the company is referred to as second generation lease activity) related to leases commencing during the reporting period, and adjusted for certain non-cash items including straight line rental income and expense, non-cash components of interest expense and stock compensation expense, and after similar adjustments for unconsolidated partnerships and joint ventures.

Exhibit II

Balance Sheets

(unaudited and in thousands)

	March 31, 2014	December 31, 2013	September 30, 2013	June 30, 2013	March 31, 2013
Assets:					
Rental property	$7,096,174	$7,031,660	$7,234,934	$7,094,986	$6,727,590
Accumulated depreciation	(1,422,986)	(1,382,757)	(1,406,849)	(1,364,439)	(1,346,961)
Construction in progress	277,400	256,911	198,988	266,388	303,383
Undeveloped land	570,718	590,052	580,052	621,143	607,283
Net real estate investments	6,521,306	6,495,866	6,607,125	6,618,078	6,291,295
Cash and cash equivalents	19,474	19,275	24,112	21,402	307,167
Accounts receivable	34,883	26,664	20,411	21,148	21,380
Straight-line rents receivable	126,387	120,497	127,311	124,951	123,108
Receivables on construction contracts, including retentions	27,833	19,209	28,706	30,205	27,465
Investments in and advances to unconsolidated companies	336,060	342,947	328,660	327,698	331,041
Deferred financing costs, net	33,764	36,250	38,029	40,837	41,097
Deferred leasing and other costs, net	462,176	473,413	502,714	523,100	489,621
Escrow deposits and other assets	205,480	218,493	209,771	176,483	169,925
Total assets	$7,767,363	$7,752,614	$7,886,839	$7,883,902	$7,802,099
Liabilities and Equity:					
Secured debt	$1,077,468	$1,100,124	$1,158,456	$1,241,527	$1,151,660
Unsecured debt	3,065,742	3,066,252	3,066,755	3,067,250	3,242,737
Unsecured line of credit	180,000	88,000	210,000	88,000	0
Construction payables and amounts due subcontractors	72,695	69,391	79,180	87,730	81,044
Accrued real estate taxes	77,301	75,396	105,263	86,968	78,985
Accrued interest	36,468	52,824	36,439	58,426	41,626
Other accrued expenses	52,118	68,276	40,983	45,078	33,586
Other liabilities	138,602	142,589	130,508	123,649	123,914
Tenant security deposits and prepaid rents	50,307	45,133	46,311	42,808	43,966
Total liabilities	4,750,701	4,707,985	4,873,895	4,841,436	4,797,518
Preferred stock	428,926	447,683	447,683	447,683	447,683
Common stock and additional paid-in capital	4,653,199	4,624,228	4,604,477	4,571,131	4,540,121
Accumulated other comprehensive income	3,832	4,119	3,780	3,950	3,228
Distributions in excess of net income	(2,100,245)	(2,062,787)	(2,076,299)	(2,014,399)	(2,020,455)
Total shareholders' equity	2,985,712	3,013,243	2,979,641	3,008,365	2,970,577
Noncontrolling interest	30,950	31,386	33,303	34,101	34,004
Total liabilities and equity	$7,767,363	$7,752,614	$7,886,839	$7,883,902	$7,802,099

Exhibit II

Statements of Operations

(unaudited and in thousands)

	Three Months Ended		
	March 31, 2014	March 31, 2013	% Change
Revenues:			
Rental and related revenue	**$237,350**	$209,879	13%
General contractor and service fee revenue	**55,820**	47,404	18%
	293,170	257,283	14%
Expenses:			
Rental expenses	**50,267**	38,861	29%
Real estate taxes	**32,467**	29,040	12%
General contractor and other services expenses	**47,271**	38,341	23%
Depreciation and amortization	**98,059**	92,993	5%
	228,064	199,235	14%
Other Operating Activities:			
Equity in earnings of unconsolidated companies	**2,321**	49,378	-95%
Gain on sale of properties	**15,853**	168	9336%
Gain on land sales	**152**	0	
Undeveloped land carrying costs	**(2,124)**	(2,198)	3%
Other operating expenses	**(92)**	(68)	-35%
General and administrative expenses	**(14,694)**	(13,145)	-12%
	1,416	34,135	-96%
Operating income	**66,522**	92,183	-28%
Other Income (Expenses):			
Interest and other income, net	**351**	153	129%
Interest expense	**(55,257)**	(57,181)	3%
Acquisition-related activity	**(14)**	643	-102%
Income tax expense (1)	**(2,674)**	0	
Income from continuing operations	**8,928**	35,798	-75%
Discontinued Operations:			
Loss before gain on sales	**(132)**	(629)	79%
Gain on sale of depreciable properties, net of tax	**16,775**	8,954	87%
Income from discontinued operations	**16,643**	8,325	100%
Net income	**25,571**	44,123	-42%
Dividends on preferred shares	**(7,037)**	(9,550)	26%
Adjustments for redemption/repurchase of preferred shares	**483**	(5,932)	0%
Net income attributable to noncontrolling interests	**(334)**	(598)	44%
Net income attributable to common shareholders	**$18,683**	$28,043	-33%
Basic net income per common share:			
Continuing operations attributable to common shareholders (2)	**$0.01**	$0.06	-83%
Discontinued operations attributable to common shareholders	**$0.05**	$0.03	67%
Total	**$0.06**	$0.09	-33%
Diluted net income per common share:			
Continuing operations attributable to common shareholders (2)	**$0.01**	$0.06	-83%
Discontinued operations attributable to common shareholders	**$0.05**	$0.03	67%
Total	**$0.06**	$0.09	-33%
Weighted average number of common shares outstanding	**327,106**	314,936	
Weighted average number of common shares and potential dilutive securities	**331,716**	319,571	

(1) The income tax expense included in continuing operations during the three months ended March 31, 2014 was triggered by the sale of one property during that time period, which was partially owned by our taxable REIT subsidiary, but due to continuing involvement in managing the property, was not classified as a discontinued operation.

(2) Dividends on preferred shares and adjustments for the redemption/repurchase of preferred shares are allocated entirely to continuing operations for basic and diluted net income (loss) per common share.

Exhibit II

Statements of FFO

(unaudited and in thousands)

	Three Months Ended	
	March 31, 2014	March 31, 2013
Rental Operations		
Revenues:		
Rental and related revenue from continuing operations	**$235,308**	$208,048
Lease buyouts	**2,042**	1,831
Revenues from continuing rental operations	**237,350**	209,879
Rental and related revenue from discontinued operations	**1,368**	16,404
	238,718	226,283
Operating expenses:		
Rental expenses	**50,267**	38,861
Real estate taxes	**32,467**	29,040
Operating expenses from discontinued operations	**913**	5,986
	83,647	73,887
FFO from rental operations	**155,071**	152,396
Unconsolidated Subsidiaries		
FFO from unconsolidated subsidiaries	**9,117**	8,497
Service Operations		
General contractor and service fee revenue	**55,820**	47,404
General contractor and other services expenses	**(47,271)**	(38,341)
FFO from fee based Service Operations	**8,549**	9,063
FFO from Operations	**172,737**	169,956
Gain on land sales	**152**	0
Undeveloped land carrying costs	**(2,124)**	(2,198)
Other operating expenses	**(92)**	(68)
General and administrative expenses	**(14,694)**	(13,145)
Interest and other income, net	**351**	153
Interest expense	**(55,257)**	(57,181)
Interest expense from discontinued operations	**(382)**	(4,260)
Dividends on preferred shares	**(7,037)**	(9,550)
Adjustments for redemption/repurchase of preferred shares	**483**	(5,932)
Acquisition-related activity	**(14)**	643
Noncontrolling interest share of FFO from consolidated subsidiaries	**(319)**	(510)
Diluted Funds from Operations - NAREIT	**$93,804**	$77,908
Less gain on land sales	**(152)**	0
Add back adjustments for redemption/repurchase of preferred shares	**(483)**	5,932
Add back acquisition-related activity	**14**	(643)
Diluted Core Funds from Operations	**$93,183**	$83,197
Weighted average number of common shares and potential dilutive securities	**334,380**	322,439
Diluted FFO per share	**$0.28**	$0.24
Diluted Core FFO per share	**$0.28**	$0.26

Exhibit II

Summary of EPS, FFO and AFFO

(unaudited and in thousands)

	Three Months Ended March 31 (Unaudited)					
	2014			2013		
	Amount	Wtd. Avg. Shares	Per Share	Amount	Wtd. Avg. Shares	Per Share
Net income attributable to common shareholders	$18,683			$28,043		
Less dividends on participating securities	(645)			(688)		
Net Income Per Common Share-Basic	18,038	327,106	$0.06	27,355	314,936	$0.09
Add back:						
Noncontrolling interest in earnings of unitholders	250	4,387		392	4,405	
Other potentially dilutive securities		223			230	
Net Income Attributable to Common Shareholders-Diluted	**$18,288**	**331,716**	**$0.06**	**$27,747**	**319,571**	**$0.09**
Reconciliation to Funds From Operations ("FFO")						
Net Income Attributable to Common Shareholders	$18,683	327,106		$28,043	314,936	
Adjustments:						
Depreciation and amortization	98,264			99,780		
Company share of joint venture depreciation, amortization and other	6,396			7,629		
Gains on depreciable property sales, net of tax-wholly owned, discontinued operations	(16,775)			(8,954)		
Gains on depreciable property sales, net of tax-wholly owned, continuing operations	(13,179)			(168)		
Gains/losses on depreciable property sales-JV	165			(48,814)		
Noncontrolling interest share of adjustments	(991)			(682)		
Funds From Operations-Basic	92,563	327,106	$0.28	76,834	314,936	$0.24
Noncontrolling interest in income of unitholders	250	4,387		392	4,405	
Noncontrolling interest share of adjustments	991			682		
Other potentially dilutive securities		2,887			3,098	
Funds From Operations-Diluted	**$93,804**	**334,380**	**$0.28**	**$77,908**	**322,439**	**$0.24**
Gain on land sales	(152)			-		
Adjustments for redemption/repurchase of preferred shares	(483)			5,932		
Acquisition-related activity	14			(643)		
Core Funds From Operations - Diluted	**$93,183**	**334,380**	**$0.28**	**$83,197**	**322,439**	**$0.26**
Adjusted Funds From Operations						
Core Funds From Operations - Diluted	$93,183	334,380	$0.28	$83,197	322,439	$0.26
Adjustments:						
Straight-line rental income and expense	(6,701)			(5,891)		
Amortization of above/below market rents and concessions	2,468			2,210		
Stock based compensation expense	8,277			6,854		
Noncash interest expense	1,602			2,310		
Second generation concessions	(76)			(68)		
Second generation tenant improvements	(7,461)			(7,859)		
Second generation leasing commissions	(6,902)			(5,636)		
Building improvements	(337)			(634)		
Adjusted Funds From Operations - Diluted	**$84,053**	**334,380**	**$0.25**	**$74,483**	**322,439**	**$0.23**
Dividends Declared Per Common Share			$0.170			$0.170
Payout Ratio of Core Funds From Operations - Diluted			60.71%			65.38%
Payout Ratio of Adjusted Funds From Operations - Diluted			68.00%			73.91%

Exhibit II

Discontinued Operations Disclosure

(unaudited and in thousands)

	Three Months Ended	
	March 31, 2014	March 31, 2013
Properties Comprising Discontinued Operations (1):		
Income Statement:		
Revenues	**$1,368**	$16,404
Operating expenses	**(913)**	(5,986)
Depreciation and amortization	**(205)**	(6,787)
Operating income	**250**	3,631
Interest expense	**(382)**	(4,260)
Gain on sale of depreciable properties	**19,752**	8,954
Income from discontinued operations before income taxes	**19,620**	8,325
Income tax expense (2)	**(2,977)**	0
Income from discontinued operations	**$16,643**	$8,325

(1) The amounts classified in discontinued operations for the periods ended March 31, 2014 and March 31, 2013 are comprised of three properties that are currently held for sale, ten properties sold in the three months ended March 31, 2014 and 25 properties sold during the year ended December 31, 2013.

Excluded from the above is one property that was sold during the three months ended March 31, 2014 and 13 properties that were sold during the year ended December 31, 2013 and, as a result of our maintaining varying forms of continuing involvement after the sale, did not meet the criteria to be classified in discontinued operations.

(2) The income tax expense included in discontinued operations during the three months ended March 31, 2014 was triggered by the sale of one property during that time period, which was partially owned by our taxable REIT subsidiary.

Exhibit II

Selected Financial Information

(unaudited and in thousands)

	Three Months Ended	
	March 31, 2014	March 31, 2013
Revenues from continuing operations	**$293,170**	$257,283
Revenues from discontinued operations	**1,368**	16,404
Total revenues	**$294,538**	$273,687
Calculation of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)		
Net income	**$25,571**	$44,123
Add depreciation and amortization - continuing operations	**98,059**	92,993
Add depreciation and amortization - discontinued operations	**205**	6,787
Add interest expense - continuing operations	**55,257**	57,181
Add interest expense - discontinued operations	**382**	4,260
Add income tax expense - continuing and discontinued operations (1)	**5,651**	0
EBITDA, prior to adjustments for joint ventures	**$185,125**	$205,344
Less pre-tax gains on depreciable property sales	**(35,605)**	(9,122)
Less gains/losses on depreciable property sales - Company's share of JV	**165**	(48,814)
Less gains on land sales	**(152)**	0
Add acquisition-related activity	**14**	(643)
Core EBITDA, prior to adjustments for joint ventures	**$149,547**	$146,765
Add back gains (losses) on depreciable property sales - Company's share of JV	**(165)**	48,814
Less equity in earnings	**(2,321)**	(49,378)
Company's share of JV EBITDA	**12,608**	13,144
Core EBITDA, including share of joint ventures	**$159,669**	$159,345
Components of Fixed Charges		
Interest expense, including discontinued operations	**$55,639**	$61,441
Company's share of JV interest expense	**3,084**	5,508
Capitalized interest	**4,170**	4,660
Company's share of JV capitalized interest	**54**	0
Interest costs for Fixed Charge reporting	**$62,947**	$71,609
Dividends on preferred shares	**7,037**	9,550
Total Fixed Charges	**$69,984**	$81,159
Common dividends paid	**$55,596**	$54,678
Unit distributions paid	**$746**	$751
Acquired lease-based intangible assets (included within deferred leasing and other costs)	**$394,497**	$398,717
Accumulated amortization on acquired lease-based intangible assets	**($159,762)**	($142,981)
Acquired lease based intangible assets, net	**$234,735**	$255,736
Common shares outstanding	**328,480**	321,667
Partnership units outstanding	**4,387**	4,388
Total common shares and units outstanding at end of period	**332,867**	326,055
Common Equity Market Capitalization (2)	**$5,618,795**	$5,536,414
Total Market Capitalization (3)	**$10,370,930**	$10,378,486

Note: Amounts shown represent continuing and discontinued operations except where noted.

(1) Income tax expense for the three months ended March 31, 2014 was the result of the sale of two properties partially owned by our taxable REIT subsidiary.

(2) Number of common shares and partnership units outstanding multiplied by the Company's closing share price at the end of each reporting period.

(3) Common Equity Market Capitalization plus face or redemption value of outstanding debt and preferred stock.

Exhibit II

Ratio Summary

(dollars in thousands)

	March 31, 2014	December 31, 2013	September 30, 2013	June 30, 2013	March 31, 2013
Effective Leverage (Debt + Company's Share of JV Debt) / (Total Assets + Accumulated Depreciation + Company's Share of JV Gross Assets)	**46%**	**46%**	**47%**	**47%**	**48%**
Debt to Total Market Capitalization (Debt / Total Market Capitalization as defined on page 11)	**42%**	**44%**	**44%**	**44%**	**42%**
Effective Leverage with Preferred Stock (Debt + Share of JV Debt + Preferred Stock) / (Total Assets + Accumulated Depreciation + Company's Share of JV Gross Assets)	**51%**	**50%**	**52%**	**52%**	**52%**
Debt plus Preferred to Total Market Capitalization ((Debt + Preferred Stock) / Total Market Capitalization as defined on page 11)	**46%**	**49%**	**49%**	**49%**	**47%**
Net Debt (Debt - Cash + Share of JV Debt) to Core EBITDA, Including Share of Joint Ventures:					
Trailing twelve months	**7.1**	**7.0**	**7.5**	**7.5**	**7.2**
Current quarter annualized	**7.2**	**6.8**	**7.4**	**7.3**	**6.9**
Proforma current quarter annualized (*)	**7.2**				
Net Debt (Debt - Cash + Share of JV Debt) + Preferred Equity to Core EBITDA, Including Share of Joint Ventures:					
Trailing twelve months	**7.8**	**7.7**	**8.2**	**8.2**	**7.9**
Current quarter annualized	**7.9**	**7.5**	**8.1**	**8.0**	**7.6**
Proforma current quarter annualized (*)	**7.8**				
Fixed Charge Coverage Ratio (Core EBITDA, Including Joint Ventures) / Total Fixed Charges					
Trailing twelve months	**2.2**	**2.1**	**2.0**	**1.9**	**1.9**
Most recent quarter	**2.3**	**2.3**	**2.2**	**2.1**	**2.0**

(*) Proforma Calculations - Core EBITDA and Net Debt	**Three Months Ended March 31, 2014**	
Core EBITDA, including share of joint ventures	$159,669	
Proforma EBITDA adjustment for current quarter acquisition	42	(1)
Proforma EBITDA adjustment for current quarter developments placed in service	1,275	(2)
Proforma EBITDA adjustment for properties in development pipeline	11,538	(3)
Remove EBITDA related to properties sold	(368)	(4)
Proforma Core EBITDA, including share of joint ventures	$172,156	
	x 4	
Annualized proforma Core EBITDA, including share of joint ventures	$688,624	
Total debt	$4,323,210	
Less cash	(19,474)	
Share of JV debt	307,484	
Net Debt	$4,611,220	
Plus remaining costs to spend for properties in development pipeline	331,004	(3)
Proforma Net Debt	$4,942,224	
Proforma Net Debt to EBITDA	**7.2**	
Proforma Net Debt	$4,942,224	
Preferred stock	428,926	
Proforma Net Debt plus Preferred	$5,371,150	
Proforma Net Debt plus Preferred to EBITDA	**7.8**	

Notes to Proforma Calculations:

(1) Current quarter acquisition consists of one industrial building that is 100% leased, totaling approximately 407,000 square feet. Adjustment is to reflect a full quarter of operations for this property.

(2) Current quarter developments placed in service consist of one office and three medical office buildings that are 100% leased, totaling more than 392,000 square feet. Adjustment is to reflect a full quarter of operations for such properties.

(3) There are 15 industrial, eight medical office and two office properties in our development pipeline as of March 31, 2014, totaling more than 7.5 million square feet (including two industrial properties, totaling approximately 1.8 million square feet, within one of our unconsolidated joint ventures). These properties have projected stabilized costs of more than $607.2 million (with the joint venture development costs reflected at our ownership percentage) and are 86% pre-leased in the aggregate. The proforma EBITDA is calculated based on the projected stabilized yield of 7.6% for these properties. The remaining costs to spend for these properties represent the total projected stabilized costs less the costs funded through March 31, 2014.

(4) Current quarter properties sold consist of nine industrial and two medical office buildings, totaling approximately 620,000 square feet. Adjustment is to remove the pre-sale operations of these properties from Core EBITDA for the quarter.

Summary of Unsecured Public Debt Covenants

Covenant	Threshold	First Quarter '14	Fourth Quarter '13	Third Quarter '13	Second Quarter '13
Total Debt to Undepreciated Assets	<60%	48%	47%	49%	48%
Debt Service Coverage	>1.5x	2.5	2.5	2.4	2.3
Secured Debt to Undepreciated Assets	<40%	14%	14%	14%	15%
Undepreciated Unencumbered Assets to Unsecured Debt	>150%	217%	221%	215%	216%

Note: The ratios are based upon the results of Duke Realty Limited Partnership, the partnership through which Duke Realty conducts its operations, using calculations that are defined in the trust indenture.

	Three Months Ended		
Unencumbered Consolidated Assets	**March 31, 2014**		**March 31, 2013**
Number of properties	468	(1)	460
Total square feet (in thousands)	85,796	(1)	78,495
Gross book value (in thousands)	$6,091,021	(1)	$5,624,287
Annual stabilized NOI (in thousands)	$538,407	(1)	$517,895

(1) Excludes 23 wholly owned properties under development at March 31, 2014 which will be unencumbered upon completion. These properties totaled approximately 5.8 million square feet with total anticipated stabilized project costs of more than $568.3 million and anticipated stabilized NOI of more than $43.5 million.

Exhibit II

Owned Property Occupancy Analysis

(*SF in thousands*)

	March 31, 2013			June 30, 2013			September 30, 2013			December 31, 2013			March 31, 2014		
	# of Bldgs.	SF	% Leased	# of Bldgs.	SF	% Leased	# of Bldgs.	SF	% Leased	# of Bldgs.	SF	% Leased	# of Bldgs.	SF	% Leased
Stabilized or In Service Geater Than One Year:															
Bulk Distribution	481	110,458	94.0%	494	117,155	95.2%	495	118,909	95.4%	495	120,150	95.8%	487	120,539	95.2%
Suburban Office	176	20,131	84.5%	177	20,508	86.5%	177	20,507	87.2%	165	19,073	87.8%	165	19,172	88.1%
Medical Office	69	5,417	91.3%	72	5,563	93.0%	73	5,578	93.9%	63	5,298	93.7%	64	5,312	93.7%
Retail	6	1,327	85.4%	5	937	84.7%	5	937	87.1%	5	937	86.7%	5	937	87.6%
Total	732	137,334	92.4%	748	144,163	93.8%	750	145,931	94.2%	728	145,458	94.6%	721	145,959	94.2%
Unstabilized and In Service Less Than One Year: (1)															
Bulk Distribution	1	421	0.0%	2	1,021	0.0%	2	1,021	0.0%	2	1,021	33.6%	1	600	57.2%
Suburban Office	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Medical Office	1	52	52.0%	1	52	61.0%	1	52	58.1%	-	-	-	-	-	-
Retail	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total	2	473	5.7%	3	1,073	3.0%	3	1,073	2.8%	2	1,021	33.6%	1	600	57.2%
Total In-Service Portfolio:															
Bulk Distribution	482	110,879	93.6%	496	118,176	94.4%	497	119,930	94.6%	497	121,171	95.3%	488	121,139	95.0%
Suburban Office	176	20,131	84.5%	177	20,508	86.5%	177	20,507	87.2%	165	19,073	87.8%	165	19,172	88.1%
Medical Office	70	5,469	90.9%	73	5,615	92.7%	74	5,630	93.6%	63	5,298	93.7%	64	5,312	93.7%
Retail	6	1,327	85.4%	5	937	84.7%	5	937	87.1%	5	937	86.7%	5	937	87.6%
Total	734	137,807	92.1%	751	145,237	93.2%	753	147,004	93.5%	730	146,479	94.2%	722	146,559	94.0%
Properties Under Development:															
Bulk Distribution	7	3,396	75.3%	3	1,936	87.6%	3	826	70.9%	10	4,854	89.8%	15	6,673	85.5%
Suburban Office	3	703	92.8%	2	406	75.8%	3	611	84.6%	3	652	81.5%	2	452	83.2%
Medical Office	13	1,021	100.0%	13	988	100.0%	12	817	100.0%	11	590	93.0%	8	397	89.6%
Retail	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total	23	5,120	82.6%	18	3,331	89.8%	18	2,253	85.2%	24	6,095	89.2%	25	7,522	85.6%
Total Portfolio:															
Bulk Distribution	489	114,275	93.1%	499	120,112	94.3%	500	120,756	94.5%	507	126,025	95.0%	503	127,812	94.5%
Suburban Office	179	20,835	84.8%	179	20,915	86.3%	180	21,117	87.2%	168	19,724	87.6%	167	19,624	88.0%
Medical Office	83	6,491	92.4%	86	6,604	93.8%	86	6,447	94.4%	74	5,888	93.6%	72	5,709	93.4%
Retail	6	1,327	85.4%	5	937	84.7%	5	937	87.1%	5	937	86.7%	5	937	87.6%
Total	757	142,928	91.8%	769	148,567	93.1%	771	149,257	93.4%	754	152,574	94.0%	747	154,081	93.6%

Note: Percentage leased numbers are shown on a lease-up basis. Lease-up basis occupancy represents the percentage of total square feet based on executed leases without regard to whether the leases have commenced.

Note: Joint Ventures are included at 100%.

(1) Includes development projects placed in-service less than 1 year that have not reached 90% occupancy.

Exhibit II

Historical Occupancy Summary

(*SF in thousands*)

	Properties in Service (1)		Under Development		Total Portfolio	
	Total Square Feet	Percent Leased	Total Square Feet	Percent Leased	Total Square Feet	Percent Leased
December 31, 2002	105,196	87.1%	3,058	79.5%	108,254	86.8%
December 31, 2003	106,220	89.3%	2,813	72.6%	109,033	88.9%
December 31, 2004	109,987	90.9%	4,228	59.2%	114,215	89.7%
December 31, 2005	98,671	92.5%	9,005	41.7%	107,676	88.3%
December 31, 2006	110,629	92.9%	10,585	33.8%	121,214	87.7%
December 31, 2007	116,323	92.0%	16,578	50.7%	132,901	86.9%
December 31, 2008	131,049	88.8%	4,021	46.4%	135,070	87.6%
December 31, 2009	133,829	87.4%	1,620	70.0%	135,449	87.2%
December 31, 2010	136,735	89.1%	2,741	88.5%	139,476	89.1%
December 31, 2011	135,590	90.7%	913	89.1%	136,503	90.7%
December 31, 2012	141,196	93.0%	4,446	73.5%	145,642	92.4%
December 31, 2013	146,479	94.2%	6,095	89.2%	152,574	94.0%
March 31, 2014	146,559	94.0%	7,522	85.6%	154,081	93.6%

Note: Percentage leased numbers are shown on a lease-up basis. Lease-up basis occupancy represents the percentage of total square feet based on executed leases without regard to whether the leases have commenced.

Note: Joint Ventures are included at 100%.

(1) Includes unstabilized developments that have reached shell completion.

Exhibit II

FFO and NOI Reconciliation

(unaudited and in thousands)

	Three Months Ended	
	March 31, 2014	March 31, 2013
Core Funds from Operations - Diluted (page 9)	**$93,183**	$83,197
Add back: Interest expense, continuing operations	**55,257**	57,181
Add back: Interest expense, discontinued operations	**382**	4,260
Add back: Dividends on preferred shares	**7,037**	9,550
Less: Company share of joint venture depreciation, amortization and other	**(6,396)**	(7,629)
Add back: Noncontrolling interest in consolidated joint ventures	**84**	206
Core EBITDA, Prior to Adjustments for Joint Ventures (page 11)	**$149,547**	$146,765
Less: General contractor and service fee revenue, net of related expenses	**(8,549)**	(9,063)
Add back: General and administrative expenses	**14,694**	13,145
Add back: Undeveloped land carrying costs	**2,124**	2,198
Add back: Other operating expenses	**92**	68
Add back: Gains (losses) on depreciable property sales - Company's share of JV	**(165)**	48,814
Less: Equity in earnings	**(2,321)**	(49,378)
Less: Interest and other income	**(351)**	(153)
Less: Revenues not allocable to operating segments	**(979)**	(1,197)
Add back: Rental expenses and real estate taxes not allocable to operating segments	**1,671**	886
Wholly Owned Property Level NOI	**$155,763**	$152,085
Less: Revenues from discontinued operations	**(1,368)**	(16,404)
Add back: Rental expenses and real estate taxes from discontinued operations	**913**	5,986
Wholly Owned Property Level NOI from Continuing Operations	**$155,308**	$141,667
Adjustments to rental revenues (1)	**(5,549)**	(3,332)
Sold assets not in discontinued operations	**96**	(2,767)
Wholly Owned Property Level NOI - Cash Basis (page 17)	**$149,855**	$135,568
Proforma property level NOI adjustments - wholly owned properties (2)	**1,140**	388
Property level NOI - cash basis (share of JV properties)	**12,342**	11,256
Total Proforma Property Level NOI - Cash Basis (Page 17)	**$163,337**	$147,212

(1) Represents adjustments for straight line rental income and expense, amortization of above and below market rents, amortization of lease concessions, intercompany rents and termination fees.

(2) NOI is adjusted to reflect a full quarter of operations for properties that were placed in service or acquired during the quarter.

Exhibit II

Net Operating Income by Product Type

(dollars and SF in thousands)

	Bulk Distribution	Suburban Office	Medical Office	Retail	Total	
Total Wholly Owned and Joint Venture In-Service Portfolio						
Rental revenues from continuing operations	$134,002	$66,972	$33,310	$2,087	$236,371	(1)
Adjustments to rental revenues	(3,874)	(1,636)	97	(136)	(5,549)	(2)
Sold assets not in discontinued operations	-	10	86	-	96	(3)
Adjusted rental revenues	130,128	65,346	33,493	1,951	230,918	
Rental and real estate tax expenses from continuing operations	(38,219)	(29,082)	(12,916)	(846)	(81,063)	(4)
Wholly owned property level NOI-cash basis (PNOI)	91,909	36,264	20,577	1,105	149,855	
Proforma property level NOI adjustments- wholly owned properties	44	185	911	-	1,140	(5)
Wholly owned pro-forma property level NOI-cash basis	$91,953	$36,449	$21,488	$1,105	$150,995	
Property level NOI- cash basis (share of JV properties)	4,767	5,362	1,222	991	12,342	(6)
Total pro-forma property level NOI- cash basis	$96,720	$41,811	$22,710	$2,096	$163,337	
NOI % by product type	59%	26%	14%	1%		
Number of properties	486	165	63	5	719	(7)
Total square footage at 100%	120,576	19,172	5,255	937	145,939	(7)
Total square footage at economic ownership %	109,472	15,976	4,732	718	130,897	(7)
Average commencement occupancy for the three months ended 3/31/14	92.9%	86.4%	90.2%	84.9%	91.9%	(8)
Ending lease up occupancy at 3/31/14	95.0%	88.1%	93.6%	87.6%	94.0%	(9)

Note: **NOI information is for the three months ended March 31, 2014 and includes only wholly owned and joint venture in-service properties as of March 31,2014. Joint venture property NOI is shown at economic ownership percentage. Sold properties and projects designated as held for sale have been excluded.**

Note: **See page 19 for further detail regarding the composition of our in-service portfolio.**

Note: **Three properties are classified as held for sale, and treated as discontinued operations, at March 31, 2014 and, as such, are not included in the schedule above. These properties generated $729 of NOI during the three months ended March 31, 2014 and had a gross basis of $39,339 as of March 31, 2014.**

(1) Rental revenues from continuing operations as included in the segment reporting disclosures in the notes to our consolidated financial statements. Revenues not allocated to reportable segments, which are not included above, totaled $979 for the three months ended March 31, 2014.

(2) Represents adjustments for straight line rental income and expense, amortization of above and below market rents, amortization of lease concessions, intercompany rents and lease termination fees.

(3) Represents properties that were sold but not included in discontinued operations due primarily to ongoing property management agreements.

(4) Rental and real estate taxes as used in the computation of PNOI from the segment reporting disclosures in the notes to our consolidated financial statements. Rental expenses and real estate taxes not allocated to reportable segments, which are not included above, totaled $1,671 for the three months ended March 31,2014.

(5) NOI is adjusted to reflect a full quarter of operations for properties that were placed in service or acquired during the quarter.

(6) NOI for joint venture properties is presented at Duke's effective ownership percentage.

(7) Number of properties, total square footage at 100% and total square footage at economic ownership % exclude two industrial buildings (563,000 SF) and one medical office building (57,000 SF) that are held for sale and included in discontinued operations.

(8) Commencement occupancy represents the percentage of total square feet where the leases have commenced.

(9) Lease up occupancy represents the percentage of total square feet based on executed leases without regard to whether the leases have commenced.

Exhibit II

Net Operating Income

(dollars and SF in thousands)

	Bulk Distribution	Suburban Office	Medical Office	Retail	Total
Stabilized Properties Generating Positive NOI (1)					
Total pro-forma property level NOI-cash basis, included in total from page 18	$ 97,928	$ 42,688	$ 22,710	$ 2,096	$ 165,421
Gross book value (4)	$4,868,181	$2,099,676	$ 1,233,091	$209,983	$8,410,931
Number of properties	465	154	63	5	687
Average age	11.8	14.9	6.1	8.0	11.9
Total square footage at 100%	116,096	18,110	5,254	937	140,396
Total square footage at economic ownership %	105,309	14,949	4,732	718	125,708
Average commencement occupancy for the three months ended 3/31/14	95.4%	88.3%	90.2%	84.9%	94.2%
Lease up occupancy at 3/31/14	96.6%	90.1%	93.6%	87.6%	95.6%
Stabilized Properties with Negative NOI (2)					
Total pro-forma property level NOI-cash basis, included in total from page 18	$ (1,185)	$ (877)	N/A	N/A	$ (2,063)
Gross book value (4)	$ 187,812	$ 113,590	N/A	N/A	$ 301,402
Number of properties	20	11	N/A	N/A	31
Average age	8.7	20.0	N/A	N/A	11.2
Total square footage at 100%	3,880	1,063	N/A	N/A	4,943
Total square footage at economic ownership %	3,863	1,026	N/A	N/A	4,890
Average commencement occupancy for the three months ended 3/31/14	23.8%	53.1%	N/A	N/A	30.1%
Lease up occupancy at 3/31/14	52.3%	54.0%	N/A	N/A	52.7%
Unstabilized Properties (3)					
Total pro-forma property level NOI-cash basis, included in total from page 18	$ (21)	N/A	N/A	N/A	$ (21)
Gross book value (4)	$ 9,543	N/A	N/A	N/A	$ 9,543
Number of properties	1	N/A	N/A	N/A	1
Average age	0.8	N/A	N/A	N/A	0.8
Total square footage at 100%	600	N/A	N/A	N/A	600
Total square footage at economic ownership %	300	N/A	N/A	N/A	300
Average commencement occupancy for the three months ended 3/31/14	57.2%	N/A	N/A	N/A	57.2%
Lease up occupancy at 3/31/14	57.2%	N/A	N/A	N/A	57.2%

Note: NOI information is for the three months ended March 31, 2014 and includes only wholly owned and joint venture in-service properties as of March 31, 2014. Joint venture property NOI is shown at economic ownership percentage. Sold properties and projects designated as held for sale have been excluded.

Note: This schedule provides supplemental information for the same population of properties presented on page 17 and 18.

Note: Three properties are classified as held for sale and treated as discontinued operations, at March 31, 2014 and, as such, are not included in the schedule above. These properties generated $729 of NOI during the three months ended March 31, 2014 and had a gross basis of $39,339 as of March 31, 2014.

(1) Represents buildings that have reached 90% occupancy and/or been in service for at least one year and that have positive NOI for the current reporting period.

(2) Represents buildings that have reached 90% lease-up occupancy and have negative NOI for the current reporting period.

(3) Represents buildings that have been in service for less than one year and have not reached 90% occupancy.

(4) Joint ventures are included at ownership percentage.

Exhibit II

Net Operating Income by Market

(dollars and SF in thousands)

Market	Net Operating Income: Bulk Distribution	Suburban Office	Medical Office	Retail	Total	Total Square Footage at Economic Ownership %: Bulk Distribution	Suburban Office	Medical Office	Retail	Total
Indianapolis	$ 11,174	$ 8,560	$ 2,165	$ 10	$ 21,909	14,917	2,812	402	38	18,170
Cincinnati	7,003	7,082	1,480	40	15,604	9,533	3,060	370	30	12,993
Dallas	8,873	539	4,184	-	13,596	10,663	200	816	-	11,678
Raleigh	3,612	7,285	1,578	52	12,527	2,801	2,297	357	20	5,475
Atlanta	6,078	1,937	4,104	-	12,119	8,370	724	891	-	9,986
South Florida	6,382	5,047	646	-	12,075	4,793	1,484	107	-	6,384
Chicago	10,528	98	976	-	11,602	10,773	20	161	-	10,954
Nashville	3,793	3,691	633	-	8,117	3,932	1,023	121	-	5,076
St. Louis	4,224	3,435	-	-	7,659	4,559	1,960	-	-	6,520
Central Florida	4,184	695	2,280	-	7,158	3,542	208	466	-	4,216
Columbus	6,684	97	-	-	6,781	8,332	51	-	-	8,383
Washington DC	612	3,626	576	-	4,814	272	728	101	-	1,101
Minneapolis	3,612	-	-	991	4,603	3,599	-	-	340	3,938
Houston	3,382	143	553	-	4,078	2,452	32	169	-	2,652
Pennsylvania	2,708	-	-	1,003	3,711	2,384	-	-	290	2,674
Savannah	3,606	-	-	-	3,606	5,318	-	-	-	5,318
Northern California	2,676	-	-	-	2,676	2,572	-	-	-	2,572
Southern California	2,557	-	-	-	2,557	1,796	-	-	-	1,796
Seattle	1,950	-	-	-	1,950	1,136	-	-	-	1,136
New Jersey	1,827	-	-	-	1,827	1,335	-	-	-	1,335
Phoenix	1,342	-	-	-	1,342	1,251	-	-	-	1,251
Baltimore	746	-	-	-	746	462	-	-	-	462
Other	375	452	3,534	-	4,362	517	350	772	-	1,638
Totals	$ 97,928	$ 42,688	$ 22,710	$ 2,096	$ 165,421	105,309	14,949	4,732	718	125,708

Note: NOI information is for the three months ended March 31, 2014 and includes only wholly owned and joint venture in-service properties as of March 31, 2014. Joint venture property NOI is shown at economic ownership percentage. Sold properties and projects designated as held for sale have been excluded.

Note: This schedule provides supplemental information for the stabilized properties generating positive NOI shown on page 18.

Exhibit II

Geographic Highlights

In Service Properties as of March 31, 2014

Primary Market	Square Feet (1) Bulk Distribution	Suburban Office	Medical Office	Retail	Overall	Percent of Overall	Average Annual Rental Revenue (2)	Percent of Annual Net Effective Rent
Indianapolis	19,524,342	2,918,233	539,157	38,366	23,020,098	15.7%	$ 92,195,992	12.8%
Cincinnati	9,626,505	3,311,264	370,180	206,315	13,514,264	9.2%	68,998,199	9.5%
Dallas	14,758,823	199,800	1,200,905	-	16,159,528	11.0%	56,664,699	7.8%
South Florida	4,915,895	1,794,523	107,000	-	6,817,418	4.7%	55,906,910	7.7%
Atlanta	8,938,350	1,249,036	890,892	-	11,078,278	7.6%	55,629,900	7.7%
Raleigh	2,800,680	2,394,831	356,836	20,061	5,572,408	3.8%	52,094,943	7.2%
Chicago	11,447,070	98,304	161,443	-	11,706,817	8.0%	48,240,791	6.7%
St. Louis	4,678,255	2,264,278	-	-	6,942,533	4.7%	39,932,968	5.5%
Nashville	3,932,110	1,167,531	120,660	-	5,220,301	3.6%	34,149,832	4.7%
Central Florida	4,268,901	415,373	465,727	-	5,150,001	3.5%	27,997,605	3.9%
Columbus	9,246,217	253,705	-	-	9,499,922	6.5%	25,403,374	3.5%
Minneapolis	3,720,250	-	-	381,922	4,102,172	2.8%	23,789,932	3.3%
Savannah	6,935,446	-	-	-	6,935,446	4.7%	19,640,725	2.7%
Houston	2,691,611	318,231	168,850	-	3,178,692	2.2%	19,331,482	2.7%
Washington DC	748,362	2,366,239	100,952	-	3,215,553	2.2%	18,265,052	2.5%
Pennsylvania	2,384,240	-	-	289,855	2,674,095	1.8%	15,899,000	2.2%
Northern California	2,571,630	-	-	-	2,571,630	1.8%	10,953,257	1.5%
Southern California	2,339,379	-	-	-	2,339,379	1.6%	10,914,228	1.5%
Seattle	1,136,109	-	-	-	1,136,109	0.8%	10,256,153	1.4%
New Jersey	1,335,464	-	-	-	1,335,464	0.9%	7,016,296	1.0%
Phoenix	2,058,316	-	-	-	2,058,316	1.4%	5,241,798	0.7%
Baltimore	462,070	-	-	-	462,070	0.3%	2,696,875	0.4%
Other	618,944	420,869	829,044	-	1,868,857	1.3%	21,667,161	3.0% (3)
Total	121,138,969	19,172,217	5,311,646	936,519	146,559,351	100.0%	$ 722,887,174	100.0%
% of Square Feet	82.7%	13.1%	3.6%	0.6%	100.0%			

Primary Market	Occupancy % Bulk Distribution	Suburban Office	Medical Office	Retail	Overall
Indianapolis	97.3%	93.4%	97.1%	92.1%	96.8%
Cincinnati	97.5%	84.8%	98.4%	100.0%	94.4%
Dallas	97.1%	100.0%	95.7%	-	97.1%
South Florida	91.4%	92.2%	100.0%	-	91.7%
Atlanta	89.3%	92.3%	95.7%	-	90.2%
Raleigh	95.8%	95.2%	97.2%	71.7%	95.5%
Chicago	98.0%	100.0%	98.9%	-	98.0%
St. Louis	95.5%	80.6%	-	-	90.7%
Nashville	81.0%	94.4%	100.0%	-	84.4%
Central Florida	93.6%	92.1%	81.3%	-	92.4%
Columbus	99.2%	75.4%	-	-	98.5%
Minneapolis	95.3%	-	-	82.5%	94.1%
Savannah	87.7%	-	-	-	87.7%
Houston	100.0%	100.0%	85.0%	-	99.2%
Washington DC	93.4%	80.3%	100.0%	-	84.0%
Pennsylvania	100.0%	-	-	85.9%	98.5%
Northern California	100.0%	-	-	-	100.0%
Southern California	76.8%	-	-	-	76.8%
Seattle	100.0%	-	-	-	100.0%
New Jersey	100.0%	-	-	-	100.0%
Phoenix	96.3%	-	-	-	96.3%
Baltimore	100.0%	-	-	-	100.0%
Other **(3)**	82.0%	58.6%	87.8%	-	79.3%
Total	95.0%	88.1%	93.7%	87.6%	94.0%

(1) Includes all wholly owned and joint venture projects shown at 100% as of report date.

(2) Annualized rental revenue represents average annual base rental payments, on a straight-line basis for the term of each lease, from space leased to tenants at the end of the most recent reporting period. Annualized rental revenue excludes additional amounts paid by tenants as reimbursement for operating expenses and real estate taxes, as well as percentage rents. Joint venture properties are included at the Company's economic ownership percentage.

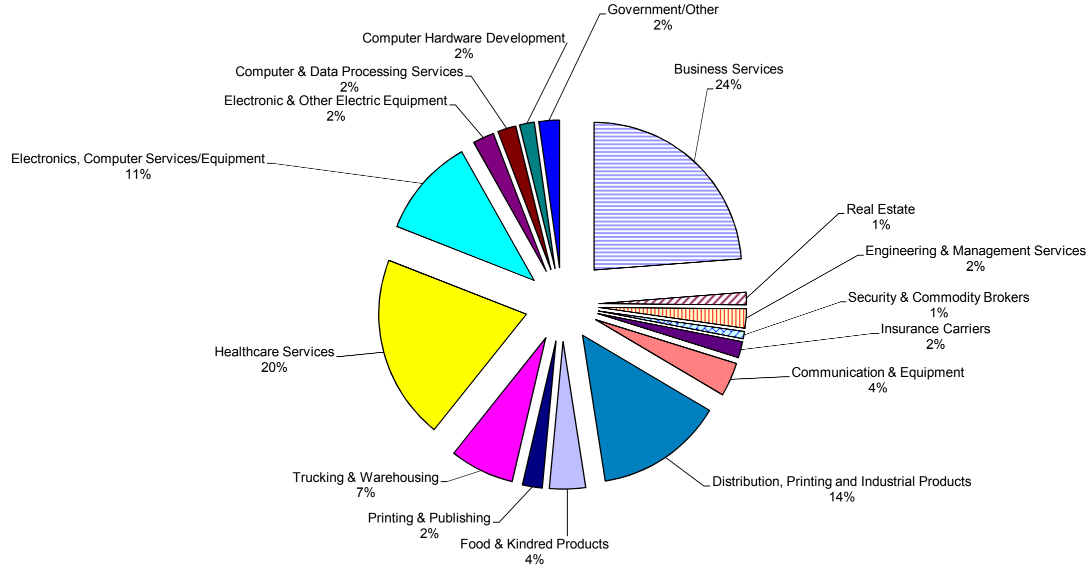
(3) Represents properties not located in the company's primary markets.

Exhibit II

Tenant Industry Profile and Largest Tenant Summary

March 31, 2014

Tenant Industry Profile as a Percentage of Annualized Gross Effective Rent (1)



Largest Tenants (In-Service Properties) Based Upon Annualized Gross Rent

Tenant	Primary Location	Primary Industry	Year of Lease Expiration	Average Annual Gross Effective Rent (1) (In Thousands)	Percentage of Annualized Gross Effective Rent
Baylor Scott & White Healthcare	Dallas	Healthcare Services	2014 - 2029	$20,201	2.5%
U.S. Government Agencies	South Florida	U.S. Government	2014 - 2034	17,126	2.2%
Amazon.com	Seattle	Retail	2017 - 2028	15,521	2.0%
Ascension Health	Other Midwest	Healthcare Services	2015 - 2029	10,226	1.3%
Lenovo Inc.	Raleigh	Computer Hardware Development	2020	9,558	1.2%
Crate and Barrel	New Jersey	Retail	2020 - 2022	8,236	1.0%
Mars, Incorporated	Columbus	Manufacturing/Agriculture	2014 - 2023	7,165	0.9%
Harbin Clinic	Atlanta	Healthcare Services	2027	7,093	0.9%
Home Depot	Northern California	Retail	2015 - 2024	6,377	0.8%
Interactive Intelligence	Indianapolis	Computer Software Services	2016 - 2019	6,194	0.8%
Northside Hospital Health Syst	Atlanta	Healthcare Services	2014 - 2023	6,169	0.8%
Tenet Healthcare Corp.	Dallas	Healthcare Services	2022 - 2030	5,846	0.7%
Schneider National	Savannah	Distribution/Warehousing	2014 - 2023	5,680	0.7%
Carolinas Healthcare System	Raleigh	Healthcare Services	2020	5,375	0.7%
Adventist Health	Central Florida	Healthcare Services	2014 - 2028	5,273	0.7%
Restoration Hardware	Columbus	Retail	2028	5,121	0.6%
Mercy	St. Louis	Healthcare Services	2014 - 2019	5,015	0.6%
Catholic Health Initiatives	Cincinnati	Healthcare Services	2021 - 2028	4,944	0.6%
Genco Distribution Systems	Indianapolis	Distribution/Warehousing	2014 - 2016	4,781	0.6%
CEVA Group PLC	Chicago	Distribution/Warehousing	2014 - 2020	4,728	0.6%
				$160,629	20.1%

(1) Represents average annual gross effective rents due from tenants in service as of March 31, 2014. Average annual gross effective rent equals the average annual rental property revenue over the terms of the respective leases including landlord operating expense allowance and excluding additional rent due as operating expense reimbursements and percentage rents.

Note: Joint ventures are included at the Company's economic ownership percentage.

Exhibit II

Same Property Performance

All Properties:	Three Months Ended March 31, 2014 and 2013: Bulk Distribution	Suburban Office	Medical Office	Retail	Total	Twelve Months Ended March 31, 2014 and 2013: Bulk Distribution	Suburban Office	Medical Office	Retail	Total
Number of properties (3)	446	156	25	4	631	446	156	25	4	631
Square feet	89,210,870	14,467,633	2,048,239	688,193	106,414,934	89,210,870	14,467,633	2,048,239	688,193	106,414,934
Percent of in-service properties	81.1%	90.6%	42.8%	95.9%	80.9%	81.1%	90.6%	42.8%	95.9%	80.9%
2014 Average Commencement Occupancy (1)	93.9%	85.6%	89.1%	80.8%	92.6%	93.8%	84.1%	88.6%	79.2%	92.3%
Period over period percent change	0.4%	3.7%	0.9%	3.6%	0.8%	1.0%	2.8%	1.0%	0.6%	1.2%

	Three Months Ended March 31: 2014	2013	% Change		Twelve Months Ended March 31: 2014	2013	% Change
				Bulk Distribution			
Total operating revenues	$ 112,037,791	$ 105,505,806	6.2%		$ 432,520,086	$ 416,584,839	3.8%
Total operating expenses	37,308,301	32,423,761	15.1%		130,431,514	122,735,346	6.3%
Net Operating Income (2)	$ 74,729,491	$ 73,082,045	2.3%		$ 302,088,572	$ 293,849,493	2.8%
				Suburban Office			
Total operating revenues	$ 67,757,406	$ 63,971,543	5.9%		$ 263,216,223	$ 252,794,131	4.1%
Total operating expenses	30,602,054	27,764,196	10.2%		114,777,650	110,523,242	3.8%
Net Operating Income (2)	$ 37,155,352	$ 36,207,347	2.6%		$ 148,438,573	$ 142,270,889	4.3%
				Medical Office			
Total operating revenues	$ 14,462,284	$ 13,435,853	7.6%		$ 55,758,912	$ 53,556,093	4.1%
Total operating expenses	6,298,683	5,580,943	12.9%		23,440,138	22,356,186	4.8%
Net Operating Income (2)	$ 8,163,601	$ 7,854,911	3.9%		$ 32,318,774	$ 31,199,907	3.6%
				Retail			
Total operating revenues	$ 4,492,438	$ 4,342,731	3.4%		$ 17,080,577	$ 16,987,728	0.5%
Total operating expenses	2,615,477	2,242,168	16.6%		9,036,786	7,897,900	14.4%
Net Operating Income (2)	$ 1,876,960	$ 2,100,563	-10.6%		$ 8,043,791	$ 9,089,828	-11.5%
				Total			
Total operating revenues	$ 198,749,919	$ 187,255,934	6.1%		$ 768,575,799	$ 739,922,791	3.9%
Total operating expenses	76,824,515	68,011,068	13.0%		277,686,088	263,512,674	5.4%
Net Operating Income (2)	**$ 121,925,405**	**$ 119,244,866**	**2.2%**		**$ 490,889,710**	**$ 476,410,116**	**3.0%**

Note: All information for joint venture properties is presented at Duke's effective ownership percentage.

(1) Commencement occupancy represents the percentage of total square feet where the leases have commenced.

(2) Net Operating Income (NOI) is equal to FFO excluding the effects of straight-line rent, concession amortization and market lease amortization.

(3) The population for determining same property performance includes both consolidated and joint venture properties. In order not to distort trends due to non-operating events, properties with termination fees over $250,000 have been excluded from both periods shown. The population, for both periods shown, consists of the 722 in-service properties that we own or jointly control, as of March 31, 2014, less (i) 47 in-service buildings that were acquired within the last 24 months, (ii) 26 in-service buildings we developed that were placed in service within the last 24 months, (iii) 15 in-service buildings that have recognized income from a lease termination fee of greater than $250,000 within the last 24 months and (iv) 3 in-service buildings that are under contract to sell at March 31, 2014 and are classified as held-for-sale for accounting purposes.

Exhibit II

Lease Expiration Comparison - Square Feet and Annualized Net Effective Rent

In-Service Properties as of March 31, 2014

(dollars and SF in thousands)

Wholly Owned Portfolio:	Total Portfolio			Bulk Distribution Portfolio		Suburban Office Portfolio		Medical Office Portfolio		Retail Portfolio	
Year of Expiration	Square Feet	Average Annual Rental Revenue (1)	%	Square Feet	Average Annual Rental Revenue (1)	Square Feet	Average Annual Rental Revenue (1)	Square Feet	Average Annual Rental Revenue (1)	Square Feet	Average Annual Rental Revenue (1)
2014	7,554	$ 37,520	6%	6,460	$ 24,478	985	$ 11,253	105	$ 1,669	4	$ 120
2015	12,713	63,955	10%	10,985	41,362	1,663	21,265	57	1,152	8	176
2016	14,667	74,647	11%	12,645	46,587	1,794	23,453	209	4,250	19	357
2017	14,326	74,653	11%	12,663	49,986	1,407	19,102	183	3,842	73	1,723
2018	12,525	75,548	11%	10,188	39,124	1,872	25,145	388	9,807	77	1,472
2019	11,660	65,132	10%	9,860	38,354	1,531	20,088	257	6,406	12	284
2020	10,807	61,512	9%	9,354	37,659	986	14,576	457	9,020	10	257
2021	7,443	42,451	6%	6,280	24,984	912	11,613	238	5,582	13	272
2022	5,920	29,731	4%	5,333	18,230	246	4,339	319	6,715	22	447
2023	2,883	24,489	4%	2,101	10,518	465	7,366	311	6,456	6	149
2024 and Therafter	16,183	117,592	18%	13,385	59,253	1,003	14,751	1,743	42,946	52	642
	116,681	$ 667,230	100%	99,254	$ 390,535	12,864	$ 172,951	4,267	$ 97,845	296	$ 5,899
Total Portfolio Square Feet	124,146			104,590		14,628		4,580		348	
Percent Leased - Lease up Basis (2)	94.0%			94.9%		87.9%		93.2%		85.7%	
Joint Venture Portfolio:											
2014	1,483	$ 3,280	6%	1,334	$ 2,239	146	$ 973	-	$ -	3	$ 68
2015	1,981	7,743	14%	967	1,570	1,014	6,173	-	-	-	-
2016	2,256	5,341	10%	1,867	2,912	373	2,126	1	3	15	300
2017	1,330	3,387	6%	1,007	1,749	316	1,638	-	-	7	-
2018	3,313	6,957	12%	2,296	2,126	800	4,332	-	-	217	499
2019	3,667	4,379	8%	3,350	2,359	309	1,750	-	-	8	270
2020	542	3,068	6%	417	846	50	326	-	-	75	1,896
2021	2,596	3,959	7%	2,449	2,572	120	805	6	27	21	555
2022	707	3,117	6%	414	601	284	2,238	-	-	9	278
2023	233	1,034	2%	121	67	102	880	-	-	10	87
2024 and Therafter	2,987	13,392	23%	1,621	2,441	508	2,207	702	4,708	156	4,036
	21,095	$ 55,657	100%	15,843	$ 19,482	4,022	$ 23,448	709	$ 4,738	521	$ 7,989
Total Portfolio Square Feet	22,413			16,549		4,544		732		588	
Percent Leased - Lease up Basis (2)	94.1%			95.7%		88.5%		96.8%		88.6%	
Total:											
2014	9,037	$ 40,800	6%	7,794	$ 26,717	1,131	$ 12,226	105	$ 1,669	7	$ 188
2015	14,694	71,698	10%	11,952	42,932	2,677	27,438	57	1,152	8	176
2016	16,923	79,988	11%	14,512	49,499	2,167	25,579	210	4,253	34	657
2017	15,656	78,040	11%	13,670	51,735	1,723	20,740	183	3,842	80	1,723
2018	15,838	82,505	11%	12,484	41,250	2,672	29,477	388	9,807	294	1,971
2019	15,327	69,511	10%	13,210	40,713	1,840	21,838	257	6,406	20	554
2020	11,349	64,580	9%	9,771	38,505	1,036	14,902	457	9,020	85	2,153
2021	10,039	46,410	6%	8,729	27,556	1,032	12,418	244	5,609	34	827
2022	6,627	32,848	5%	5,747	18,831	530	6,577	319	6,715	31	725
2023	3,116	25,523	4%	2,222	10,585	567	8,246	311	6,456	16	236
2024 and Therafter	19,170	130,984	17%	15,006	61,694	1,511	16,958	2,445	47,654	208	4,678
	137,776	$ 722,887	100%	115,097	$ 410,017	16,886	$ 196,399	4,976	$ 102,583	817	$ 13,888
Total Portfolio Square Feet	146,559			121,139		19,172		5,312		936	
Percent Leased - Lease up Basis (2)	94.0%			95.0%		88.1%		93.7%		87.6%	

(1) Annualized rental revenue represents average annual base rental payments, on a straight-line basis for the term of each lease, from space leased to tenants at the end of the most recent reporting period. Annualized rental revenue excludes additional amounts paid by tenants as reimbursement for operating expenses and real estate taxes, as well as percentage rents. Joint venture properties are included at the Company's economic ownership percentage.

(2) Lease up basis occupancy represents the percentage of total square feet based on executed leases without regard to whether the leases have commenced.

Exhibit II

New Lease Analysis

Second Generation Deals as of March 31, 2014

Product Type	Number of New Leases	Square Feet of Second Generation Spaces	2nd Generation Weighted Average Capital Expenditures: Per Sq. Ft.	2nd Generation Weighted Average Capital Expenditures: Per Sq. Ft. / Per Year of Lease Term	Average Term in Years	Average Net Effective Rent
Year Ended 2013						
Bulk Distribution	126	6,752,474	$ 4.00	$ 0.73	5.48	$ 3.63
Suburban Office	161	1,305,293	25.75	3.80	6.78	12.49
Medical Office	11	40,711	16.37	2.94	5.56	17.97
	298	8,098,478	$ 7.57	$ 1.33	5.69	$ 5.13
1st Quarter 2014						
Bulk Distribution	28	2,381,949	$ 4.98	$ 0.66	7.49	$ 3.58
Suburban Office	26	220,592	19.15	4.19	4.57	12.79
Medical Office	4	14,090	29.36	4.89	6.01	16.69
	58	2,616,631	$ 6.30	$ 0.87	7.23	$ 4.43
Year to Date 2014						
Bulk Distribution	28	2,381,949	$ 4.98	$ 0.66	7.49	$ 3.58
Suburban Office	26	220,592	19.15	4.19	4.57	12.79
Medical Office	4	14,090	29.36	4.89	6.01	16.69
	58	2,616,631	$ 6.30	$ 0.87	7.23	$ 4.43

Note: **Activity noted above does not include first generation lease-up of new development and acquisitions as these amounts are included in our initial return calculations. Activity is based on leases signed during the period and excludes temporary leases of space.**

Note: **Joint ventures are shown at 100%**

Exhibit II

Renewal Analysis

As of March 31, 2014

	Leases up for Renewal		Leases Renewed					Average Capital Expenditures		
Product Type	Number	Square Feet	Number	Square Feet	Percent Renewed (1)	Average Term in Years	Average Net Effective Rent	Per Sq. Ft.	Per Sq. Ft. / Per Year of Lease Term	Growth in Net Eff. Rent (2)
Year Ended 2013										
Bulk Distribution	240	16,446,780	159	11,286,276	68.6%	4.22	$ 4.00	$ 1.66	$ 0.39	4.31%
Suburban Office	269	2,703,532	179	2,214,216	81.9%	4.66	14.52	10.52	2.26	1.38%
Medical Office	39	138,984	22	53,433	38.4%	3.83	19.13	6.86	1.79	5.96%
	548	19,289,296	360	13,553,925	70.3%	4.29	$ 5.78	$ 3.13	$ 0.73	3.11%
1st Quarter 2014										
Bulk Distribution	50	2,694,499	36	1,784,591	66.2%	3.80	$ 4.56	$ 0.87	$ 0.23	8.29%
Suburban Office	43	295,701	22	158,011	53.4%	3.90	13.43	7.95	2.04	4.47%
Medical Office	10	32,751	4	18,153	55.4%	5.00	21.00	4.00	0.80	20.76%
	103	3,022,951	62	1,960,755	64.9%	3.82	$ 5.43	$ 1.47	$ 0.38	7.90%
Year to Date 2014										
Bulk Distribution	50	2,694,499	36	1,784,591	66.2%	3.80	$ 4.56	$ 0.87	$ 0.23	8.29%
Suburban Office	43	295,701	22	158,011	53.4%	3.90	13.43	7.95	2.04	4.47%
Medical Office	10	32,751	4	18,153	55.4%	5.00	21.00	4.00	0.80	20.76%
	103	3,022,951	62	1,960,755	64.9%	3.82	$ 5.43	$ 1.47	$ 0.38	7.90%

(1) The percentage renewed is calculated by dividing the square feet of leases renewed by the square feet of leases up for renewal. The square feet of leases up for renewal is defined as the square feet of leases renewed plus the square feet of space vacated due to lease expirations. Excludes temporary leases of space. Joint venture properties are included at 100%.

(2) Represents the percentage change in net effective rent between the original leases and the renewal leases. Net effective rent represents average annual base rental payments, on a straight-line basis for the term of each lease excluding operating expense reimbursements.

Exhibit II

Space Vacated Analysis

As of March 31, 2014

	Total	Terminations	Lease Expirations (1)		Default / Bankruptcy		Buyouts (2)		Relocations (3)		Contractions (4)	
			Space Vacated for the Following Reasons									
Year Ended 2013												
Bulk Distribution	130	8,106,662	81	5,160,504	22	1,293,566	9	800,704	6	491,805	12	360,083
Suburban Office	145	855,736	90	489,316	13	68,233	15	92,115	7	27,181	20	178,891
Medical Office	22	106,118	17	85,551	2	10,312	-	-	1	2,355	2	7,900
	297	9,068,516	188	5,735,371	37	1,372,111	24	892,819	14	521,341	34	546,874
1st Quarter 2014												
Bulk Distribution	25	2,036,855	14	909,908	2	37,102	7	860,339	1	77,281	1	152,225
Suburban Office	35	249,503	21	137,690	6	75,415	2	11,376	4	9,544	2	15,478
Medical Office	7	18,715	6	14,598	-	-	1	4,117	-	-	-	-
	67	2,305,073	41	1,062,196	8	112,517	10	875,832	5	86,825	3	167,703
Year to Date 2014												
Bulk Distribution	25	2,036,855	14	909,908	2	37,102	7	860,339	1	77,281	1	152,225
Suburban Office	35	249,503	21	137,690	6	75,415	2	11,376	4	9,544	2	15,478
Medical Office	7	18,715	6	14,598	-	-	1	4,117	-	-	-	-
	67	2,305,073	41	1,062,196	8	112,517	10	875,832	5	86,825	3	167,703

Note: Excludes temporary leases of space.

Note: Joint Ventures are shown at 100%.

(1) Represents tenants who did not renew their leases upon expiration due to the closing of their local operations, relocation to another property not owned or built by the Company, or the exercising of a termination option.

(2) Represents space with termination fees required to allow the tenants to vacate their space prior to the normal expiration of their lease term.

(3) Represents tenants who vacated their space and relocated to another property owned or built by the Company or moved out to accommodate another Duke tenant expansion.

(4) Represents tenants who have downsized prior to expiration of their lease term.

Exhibit II

Debt Maturity & Preferred Stock Analysis

March 31, 2014

(in thousands)

Year	Mortgages (1) Amortization	Mortgages (1) Maturities	Unsecured (1) Amortization	Unsecured (1) Maturities	Credit Facility (2)	Total (3)	Weighted Average Effective Interest Rates (3)
2014	$ 11,090	$ 49,406	$ 1,581	$ -	$ -	$ 62,077	6.23%
2015	12,432	193,346	2,226	250,000	180,000	638,004	5.07%
2016	9,937	368,132	2,370	150,000	-	530,439	6.14%
2017	7,616	108,129	2,523	450,000	-	568,268	5.89%
2018	5,252	-	2,685	550,000	-	557,937	4.03%
2019	4,077	268,438	2,859	250,000	-	525,374	7.97%
2020	3,883	-	1,498	250,000	-	255,381	6.73%
2021	3,416	9,047	-	250,000	-	262,463	3.99%
2022	3,611	-	-	600,000	-	603,611	4.20%
2023	3,817	-	-	250,000	-	253,817	3.75%
2024	4,036	-	-	-	-	4,036	5.62%
Thereafter	6,325	-	-	50,000	-	56,325	7.11%
	$ 75,492	$ 996,498	$ 15,742	$ 3,050,000	$ 180,000	$ 4,317,732	5.41%

(1) Scheduled amortizations and maturities represent only Duke's consolidated debt obligations.

(2) Comprised of the following:

Commitment	Balance O/S @ 3/31	Maturity	Rate @ 3/31	Type
$850,000	$180,000	December 2015	1.41%	DRLP line of credit

(3) Total debt balance and weighted average effective interest rates exclude fair value adjustments of $5,478 reflected on the balance sheet.

Fixed and Variable Rate Components of Debt	Balance	Weighted Average Interest Rate	Weighted Average Maturity (yrs)
Fixed Rate Secured Debt	$ 1,065,750	6.24%	2.81
Fixed Rate Unsecured Debt	2,815,741	5.70%	5.49
Variable Rate Debt and LOC	436,241	1.45%	2.77
Total	$ 4,317,732	5.41%	4.55

Preferred Stock Summary

Security	Dividend Rate	Liquidation Preference	Depositary Shares Outstanding	Optional Redemption Date
Series J preferred stock	6.63%	$ 96,133	3,845	Currently Redeemable
Series K preferred stock	6.50%	149,395	5,976	Currently Redeemable
Series L preferred stock	6.60%	183,399	7,336	Currently Redeemable
Weighted Average	6.57%	$ 428,926		

Exhibit II

Joint Venture Information

March 31, 2014

	Eaton/Vance	Duke Hulfish LLC	Dugan Texas	3630 Peachtree	Baylor Cancer Center	West End Retail (3)	All Points Industrial	Wishard	Linden Development (4)	Dugan Millenia	Other (5)	Total
In-service properties:												
Bulk distribution	11	7	35	-	-	-	1	-	-	-	13	67
Suburban office	20	10	-	1	-	-	-	-	-	3	1	35
Medical office	-	-	-	-	1	-	-	1	-	-	-	2
Retail	-	-	-	-	-	1	-	-	-	-	1	2
	31	17	35	1	1	1	1	1	-	3	15	106
Under development properties:												
Bulk distribution	-	-	-	-	-	-	2	-	-	-	-	2
	-	-	-	-	-	-	2	-	-	-	-	2
Total number of properties	31	17	35	1	1	1	3	1	-	3	15	108
Percent leased	86.0%	99.0%	95.3%	83.7%	94.9%	82.5%	89.1%	100.0%	N/A	92.1%	97.3%	94.5%
Square feet in-service (in thousands):												
Bulk distribution	670	6,120	6,876	-	-	-	600	-	-	-	2,283	16,549
Suburban office	2,147	1,201	-	436	-	-	-	-	-	415	345	4,544
Medical office	-	-	-	-	458	-	-	274	-	-	-	732
Retail	-	-	-	-	-	382	-	-	-	-	206	588
	2,817	7,321	6,876	436	458	382	600	274	-	415	2,834	22,413
Square feet under development (in thousands):												
Bulk distribution	-	-	-	-	-	-	1,758	-	-	-	-	1,758
	-	-	-	-	-	-	1,758	-	-	-	-	1,758
Total square feet (in thousands)	2,817	7,321	6,876	436	458	382	2,358	274	-	415	2,834	24,171
Company effective ownership percentage	30.0%	20.0%	50.0%	50.0%	16.0%	50.0%	50.0%	50.0%	50.0%	50.0%	10%-50%	
Balance sheet information (in thousands) (A)												
Real estate assets	$ 493,005	$ 384,404	$ 195,110	$ 103,327	$ 109,558	$ 113,502	$ 13,587	$ 74,422	$ -	$ 39,762	$ 96,930	$ 1,623,607
Construction in progress	151	63	508	1,075	-	43	21,558	-	148	31	895	24,472
Undeveloped land	-	-	1,657	-	-	-	43,183	-	59,920	6,204	15,608	126,572
Other assets	43,020	46,756	18,028	20,530	8,160	6,756	11,218	3,423	2,657	7,832	36,377	204,757
Total assets	$ 536,176	$ 431,223	$ 215,303	$ 124,932	$ 117,718	$ 120,301	$ 89,546	$ 77,845	$ 62,725	$ 53,829	$ 149,810	$ 1,979,408
Debt	$ 460,069	$ 79,408	$ -	$ 99,582	$ -	$ 99,400	$ 59,456	$ -	$ -	$ 35,000	$ 64,483	$ 897,398
Other liabilities	9,662	8,267	5,303	31,053	1,657	8,394	7,241	917	4,604	1,120	12,567	90,785
Equity	66,445	343,548	210,000	(5,703)	116,061	12,507	22,849	76,928	58,121	17,709	72,760	991,225
Total liabilities and equity	$ 536,176	$ 431,223	$ 215,303	$ 124,932	$ 117,718	$ 120,301	$ 89,546	$ 77,845	$ 62,725	$ 53,829	$ 149,810	$ 1,979,408
Selected QTD financial information (B)												
QTD share of rental revenue (in thousands)	$5,297	$2,954	$4,163	$1,459	$837	$2,769	$158	$1,199	-	$1,086	$560	$20,482
QTD share of in-service property unlevered NOI (in thousands)	$3,571	$2,175	$3,010	$414	$451	$945	($22)	$771	-	$675	$352	$12,342
QTD share of interest expense (in thousands)	$1,918	$208	-	$331	-	$390	$101	-	-	$105	$31	$3,084
QTD share of EBITDA (in thousands)	$3,451	$2,016	$2,941	$785	$507	$1,056	$71	$918	($93)	$644	$312	$12,608
Company share of JV gross assets (in thousands)	$194,528	$100,881	$145,228	$70,225	$20,887	$70,397	$47,036	$39,335	$31,363	$32,633	$35,223	$787,736
Interest rate (C)	(1)	(2)	N/A	L+2.5%	N/A	(3)	L+1.8%	N/A	N/A	L+1.7%	(5)	N/A
Company share of debt (in thousands)	$138,021	$15,882	N/A	$49,791	N/A	$49,700	$29,728	N/A	N/A	$17,500	$6,862	$307,484
Debt maturity date	(1)	(2)	N/A	7/15	N/A	(3)	12/14	N/A	N/A	7/16	(5)	N/A

(A) Balance sheet information is reported at 100% of joint venture. (B) Reported at Duke's share of joint venture. (C) Interest rate is fixed, except as noted.

Notes in (000's)

(1) The outstanding debt consists of nine separate loans: i) $22,587 at a fixed rate of 6.4% maturing August 2014, ii) $6,384 at a fixed rate of 8.2% maturing December of 2015, iii) $11,916 at a fixed rate of 6.0% maturing March 2016, iv) $27,765 at a fixed rate of 6.2% maturing June 2016, v) $131,250 at a fixed rate of 5.4% maturing March 2017, vi) $203,250 at a fixed rate of 5.4% maturing March 2017 , vii) $15,128 at a fixed rate of 5.6% maturing December 2019, viii) $33,879 at a fixed rate of 5.9% maturing January 2020 and ix) $6,782 at a fixed rate of 8.3% maturing November 2023.

(2) Debt consists of three separate loans: i) $13,653 at a fixed rate of 5.0% maturing September 2021, ii) $10,535 at a fixed rate of 4.4% maturing September 2021, and iii) $55,221 at a fixed rate of 5.2% maturing October 2021.

(3) Our share of in-service property revenue, unlevered NOI, EBITDA and interest expense for this joint venture is computed based on the operating cash flow distributions we would receive pursuant to our accumulated preferred return in this joint venture, which equates to our share being 89%. The debt consists of two separate loans: i) a variable rate land loan of LIBOR + 1.5% maturing September 2014, with a current amount outstanding of $14,400 and ii) a construction line of credit at LIBOR + 1.5% maturing September 2014, with a current amount outstanding of $85,000. Amounts charged by Duke to the joint venture are not included in share of interest expense above.

(4) This joint venture currently has 45.3 acres of land in Linden, New Jersey, anticipated for use to develop 450,000 square feet of retail buildings.

(5) Consists of 8 separate joint ventures that own and operate buildings and hold undeveloped land. Debt balance consists of three separate loans: i) $250 at a variable rate of LIBOR + 3.0% maturing June 2014, ii) $24,000 at a fixed rate of 8.0% maturing October 2015 and iii) $40,233 at a variable rate of LIBOR + 1.4% maturing December 2016.

Exhibit II

Joint Venture Debt Maturity Summary

March 31, 2014

(in thousands)

Year	Scheduled Amortization	Maturities	Total	Weighted Average Interest Rate
2014	$ 912	$ 86,191	$ 87,103	2.15%
2015	1,207	53,933	55,140	3.14%
2016	977	33,167	34,144	3.35%
2017	899	100,350	101,249	5.40%
2018	955	-	955	6.04%
2019	1,002	3,824	4,826	5.67%
2020	645	8,693	9,338	5.92%
2021	543	13,305	13,848	5.15%
2022	272	-	272	8.33%
2023	270	-	270	8.33%
2024	-	-	-	0.00%
Thereafter	-	-	-	0.00%
	$ 7,682	$ 299,463	$ 307,145	3.86%

	Balance	Weighted Average Interest Rate	Weighted Average Maturity (yrs)
Fixed Rate Secured Debt	$ 155,964	5.62%	3.33
Fixed Rate Unsecured Debt	-	-	0.00
Variable Rate Debt and LOC's	151,181	2.05%	0.62
Total	$ 307,145	3.86%	1.99

Note: Scheduled amortization and maturities reported at Duke's share.

Exhibit II

Development Projects Under Construction

March 31, 2014

(*in thousands*)

Project	Product Type	Market	Own %	Square Feet (000's)	Current Occ. %	Stabilized Costs (000's) (at Owner %)	Projected Costs Remaining (000's) (at Owner %)	Initial Stabilized Cash Yield	Stabilized GAAP Yield
Wholly Owned									
Grand Warehouse Expansion	Industrial	Chicago	100%	52	100%				
Centerre/Mercy	Medical Office	Other Midwest	100%	60	100%				
Perimeter Two	Office	Raleigh	100%	206	97%				
Baylor, Burleson	Medical Office	Dallas	100%	38	100%				
Projected In-Service Second Quarter 2014				356	98%				
10 Enterprise Parkway	Industrial	Columbus	100%	534	100%				
Baylor, Mansfield	Medical Office	Dallas	100%	38	100%				
Baylor, Colleyville	Medical Office	Dallas	100%	17	100%				
HH Gregg BTS	Industrial	Atlanta	100%	403	100%				
Linden Spec.	Industrial	New Jersey	100%	494	0%				
Lebanon Bldg. 2 Expansion	Industrial	Indianapolis	100%	218	100%				
Perimeter Three	Office	Raleigh	100%	245	71%				
Amazon BTS	Industrial	Baltimore	100%	1,018	100%				
Amazon BTS	Industrial	Baltimore	100%	346	100%				
Projected In-Service Third Quarter 2014				3,313	83%				
Centerre Baptist	Medical Office	Nashville	100%	53	100%				
FedEx BTS	Industrial	Atlanta	100%	77	100%				
West Chester Medical Off. Bldg	Medical Office	Cincinnati	100%	49	100%				
Gateway North 6	Industrial	Minneapolis	100%	300	100%				
Gateway Northwest One	Industrial	Houston	100%	358	0%				
Gateway Northwest Two	Industrial	Houston	100%	115	0%				
Palisades Ambulatory Care Ctr	Medical Office	New Jersey	100%	57	70%				
Projected In-Service Fourth Quarter 2014				1,009	51%				
Subtotal Projected In-Service 2014				4,678	77%				
20 Enterprise Parkway	Industrial	Columbus	100%	744	100%				
3909 North Commerce Expansion	Industrial	Atlanta	100%	257	100%				
St. Vincent Women's MOB	Medical Office	Indianapolis	100%	86	72%				
Projected In-Service First Quarter 2015				1,086	98%				
Wholly Owned Developments Under Construction				**5,764**	**81%**				
Joint Venture									
AllPoints Midwest Bldg 3	Industrial	Indianapolis	50%	1,144	100%				
AllPoints Midwest Bldg 5	Industrial	Indianapolis	50%	614	100%				
Projected In-Service Third Quarter 2014				1,758	100%				
Joint Venture Developments Under Construction				**1,758**	**100%**				
Total Company				**7,522**	**86%**	**$ 607,248**	**$ 331,004**	**7.6%**	**8.4%**

Exhibit II

Development Projects Placed In-Service

2012 - 2014
(*in thousands*)

	Wholly Owned					Joint Venture					Total				
			Initial Stabilized					Initial Stabilized					Initial Stabilized		
	Square Feet	Current Occ % (1)	Project Costs	Cash Yield	GAAP Yield	Square Feet	Current Occ % (1)	Project Costs	Cash Yield	GAAP Yield	Square Feet	Current Occ % (1)	Project Costs	Cash Yield	GAAP Yield
2012 Total	1,270	98%	$ 125,197	8.4%	8.7%	376	100%	$ 7,082	7.7%	7.9%	1,646	99%	$ 132,279	8.3%	8.7%
2013:															
1st Quarter	595	29%	40,764	6.4%	7.4%	-	-	-	-	-	595	29%	40,764	6.4%	7.4%
2nd Quarter	1,512	100%	181,920	7.7%	8.1%	600	57%	10,858	7.5%	7.9%	2,111	88%	192,778	7.7%	8.1%
3rd Quarter	1,917	100%	189,786	7.3%	7.7%	-	-	-	-	-	1,917	100%	189,786	7.3%	7.7%
4th Quarter	390	100%	63,430	7.8%	8.8%	273	100%	41,527	7.1%	8.5%	664	100%	104,957	7.5%	8.7%
2013 Total	4,414	90%	$ 475,900	7.4%	8.0%	873	71%	$ 52,385	7.2%	8.4%	5,287	87%	$ 528,285	7.4%	8.0%
2014:															
1st Quarter	392	100%	105,998	7.7%	8.7%	-	-	-	-	-	392	100%	105,998	7.7%	8.7%
2014 Total YTD	392	100%	$ 105,998	7.7%	8.7%	-	-	-	-	-	392	100%	$ 105,998	7.7%	8.7%

(1) Occupancy represents the percentage of total square feet based on executed leases without regard to whether the leases have commenced.

Note: Square feet for Joint Venture projects is shown at 100%; Project costs & returns included at Duke Realty ownership share.

Note: Excludes development projects completed which have subsequently been sold as of current quarter end.

Dispositions and Acquisitions Summary

(in thousands)

	Dispositions				Acquisitions					
	Square Feet	Sales Proceeds	In-Place Cap Rate (1)	In-Place Occ % (2)	Square Feet	Stabilized Investment (3)	Acquisition Price (4)	In-Place Occ % (5)	In-Place Cash Yield (6)	
2013										
1st Quarter	4,099	$ 222,220	7.7%	98%	472	$ 29,980	$ 28,325	97%	6.9%	(7)
2nd Quarter	617	197,645	5.0%	76%	5,937	411,729	404,980	100%	6.3%	
3rd Quarter	232	45,565	4.4%	53%	453	39,398	38,765	100%	5.7%	
4th Quarter	2,606	411,731	7.4%	91%	1,191	74,034	73,414	100%	5.5%	
Total	7,554	$ 877,161	6.8%	92%	8,053	$ 555,141	$ 545,484	100%	6.1%	(7)
2014										
1st Quarter	725	$ 78,370	7.4%	93%	407	$ 17,753	$ 17,550	100%	6.3%	
Total YTD	725	$ 78,370	7.4%	93%	407	$ 17,753	$ 17,550	100%	6.3%	

Note: Sales of joint venture properties are included at ownership share.

(1) In-place cap rates of completed dispositions are calculated as current annualized net operating income, from space leased to tenants at the date of sale, divided by the sale price of the real estate. Annualized net operating income is comprised of base rental payments, excluding reimbursement of operating expenses, less current annualized operating expenses not recovered through tenant reimbursements.

(2) Occupancy represents the percentage of total square feet based on executed leases where the leases have commenced.

(3) Represents projected stabilized investment of real estate assets acquired after stabilization costs (such as applicable closing costs, lease up costs of any vacant space acquired, and deferred maintenance costs) are added to the acquisition price.

(4) Includes real estate assets and net acquired lease-related intangible assets but excludes other acquired working capital assets and liabilities.

(5) Occupancy represents the percentage of total square feet based on executed leases without regard to whether the leases have commenced.

(6) In-place yields of completed acquisitions are calculated as the current annualized net operating income, from space leased to tenants at the date of acquisition, divided by the acquisition price of the acquired real estate. Annualized net operating income is comprised of base rental payments, excluding reimbursement of operating expenses, less current annualized operating expenses not recovered through tenant reimbursements.

(7) Price, Investment, Yield, & Occ % includes one or more acquisitions in which Duke Realty purchased a partner's interest in a joint venture.

Exhibit III

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March 17, 2014

International Financial Reporting Standards
Interpretations Committee
30 Cannon Street
London
EC4M 6XH

Subject: Tentative agenda decision – IAS 17 Leases – Meaning of incremental costs

Dear IFRS Interpretations Committee members,

This letter is submitted by the Real Property Association of Canada (REALpac) in response to the tentative agenda decision from the November 2013 discussion on IAS 17 Leases, Meaning of Incremental costs.

REALpac is Canada's senior national industry association for owners and managers of investment real estate. Our Members include publicly traded real estate companies, real estate investment trusts (REITs), private companies, pension funds, banks and life insurance companies. The association is further supported by large owner/occupiers and pension fund advisers as well as individually selected investment dealers and real estate brokerages. Members of REALpac currently own in excess of $180 Billion CAD in real estate assets located in the major centers across Canada

REALpac's Comments

The Interpretations Committee received a request for clarification about IAS 17 *Leases* related to the meaning of "incremental costs" within the context of IAS 17, and in particular, whether salary costs of permanent staff involved in negotiating and arranging new leases as a lessor qualify as "incremental costs".

We do not support the Interpretations Committee's tentative decision that internal salary costs do not qualify as incremental costs. In addition, we would assert that there is diversity in practice on this issue.

IAS 17 paragraph 38 states that "(I)nitial direct costs are often incurred by lessors and include amounts such as commissions, legal fees and internal costs that are incremental and directly attributable to negotiating and arranging a lease. They

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exclude general overheads such as those incurred by a sales and marketing team." In Canada, we consider certain internal costs as incremental and variable costs, not fixed. These costs are directly related to specific activities performed by the lessor that would not have occurred but for that successfully executed lease. Those activities may include: evaluating a prospective lessee's financial condition, evaluating and recording security arrangements, negotiating lease terms, preparing and processing lease documents and closing the lease transaction. These activities are initiated upon the prospective lessee's desire to enter into a lease, on behalf of the lessor and they relate directly to entering into the successfully executed lease. Therefore, they are integral to leasing. Among other examples, these companies typically have systems in place to track the number of successful leases completed by each internal leasing staff or time spent on successful deals in order to allocate costs (and time) to a specific lease arrangement and capitalize certain internal costs that relate to successful leases. Furthermore, these companies typically make reference to market-based rates for specific leasing activities which would establish an upper limit of what could be capitalized. Companies who make the rational business decision to minimize cost through employment of internal leasing personnel, opposed to hiring external leasing brokers should not be impacted by the accounting treatment. To make the issue even worse, some companies use both internal and external leasing. This will result in inconsistent accounting within the same company, which would make evaluating the results very difficult.

By our interpretation of paragraph 38, these internal costs meet the requirements of being both incremental and directly attributable to negotiating and arranging a lease.

In the Staff Paper (Agenda ref 7) from the November 2013 IFRIC meeting, points 21 – 26, reference is made to IAS 39, whereby an incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument." While we agree that incremental costs should be interpreted as costs that would not have been incurred if the entity had not negotiated or initiated leases, we disagree with the conclusion in points 26 and 27 that salaried employees are "permanent" and that these salaries are "fixed" costs that are "unavoidable". Particularly where companies use time-tracking systems to allocate time and costs, our viewpoint is that these costs are variable, and do fluctuate with the volume of leases that are written. If the volume of leases written decreases, so do the number of employees employed for this work, and vice versa; therefore these costs are variable and are not "unavoidable".

Based on our discussions with our counterparts in the United States, it is our understanding that our accounting for similar costs is consistent with treatment under U.S. GAAP. ASC 840-20-25-18 states:

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"The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that lease and other costs related to those activities that would not have been incurred but for that lease. Initial direct costs shall not include costs related to any of the following activities performed by the lessor:
a. Advertising
b. Soliciting potential lessees
c. Servicing existing leases
d. Other ancillary activities related to establishing and monitoring credit policies, supervision, and administration."

As active observers in the joint IASB/FASB Leases project, it is our understanding that the definition of initial direct costs under IFRS in IAS 17 and U.S. GAAP in ASC 840 is not intended to differ from current practice or from one another.

In Agenda paper 11A of the March 22-23, 2011 meeting of the IASB/FASB, the staff recommendation is "that *initial direct costs* should be defined as: Costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made." It was also noted that "(V)ery little feedback about the definition of initial direct costs was received. The staff thinks that the definition in the ED is appropriate and ***consistent with current lease guidance under Topic 840 and IAS 17. The staff notes that the proposed definition is not intended to change current practice for how initial direct costs are defined*** (emphasis added) (see Appendix A for current guidance)." Appendix A of that Agenda paper notes that:

"Under the guidance in Topic 840, initial directs costs include only those costs incurred by the lessor that are:
(a) Costs to originate a lease incurred in transactions with independent third parties that:
(i) Result directly from and are essential to acquire that lease.
(ii) Would not have been incurred had that leasing transaction not occurred.
(b) Directly related to only the following activities performed by the lessor for that lease:
(i) Evaluating the prospective lessee's financial condition
(ii) Evaluating and recording guarantees, collateral, and other security arrangements
(iii) Negotiating lease terms
(iv) Preparing and processing lease documents
(v) Closing the transaction"

Exhibit III

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It is our understanding that the capitalization of initial direct costs related to certain salaried employees engaged in arranging and negotiating leases for commercial real estate transactions is consistent across Canada and the U.S. We therefore do not agree with the Interpretation Committee's conclusion that predominant practice is to expense employee salary costs.

Overall, we believe that IAS 17 is clear that certain internal costs do qualify as incremental costs and are directly attributable to negotiating and arranging a lease. We further believe that this accounting treatment is consistent with both IFRS under IAS 17 and U.S. GAAP under ASC 840.

We thank the IFRIC for considering our comments on the tentative decision regarding the meaning of incremental costs within the context of IAS 17 Leases. Please contact Nancy Anderson, REALpac's Vice President Financial Reporting & Chief Financial Officer at nanderson@realpac.ca or at 1-416-642-2700 ext. 226 if you would like to discuss our comments.

Respectfully submitted,

NAnderson

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20 January 2014

Dear IFRS Interpretations Committee members,

Tentative agenda decision – *IAS 17 Leases – Meaning of incremental costs*

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, welcomes the opportunity to offer its views on the above tentative agenda decision, as published in the November 2013 *IFRIC Update*.

The Interpretations Committee received a request for clarification of the meaning of 'incremental costs' within the context of IAS 17 *Leases*.

"The submitter asks whether the salary costs of permanent staff involved in negotiating and arranging new leases (and loans) qualify as 'incremental costs' within the context of IAS 17 and should therefore be included as initial direct costs in the initial measurement of a finance lease receivable."

We do not support the Interpretations Committee's tentative decision not to add this issue to its agenda, as we believe preparers would benefit from additional guidance related to capitalising certain internal costs as incremental costs. IAS 17.38 clearly indicates that some internal costs are incremental and directly attributable to negotiating and arranging a lease. Without additional clarification, preparers of financial statements may find it difficult to distinguish between certain internal costs that are incremental and internal costs that are not incremental.

The IASB and FASB staffs issued agenda paper 11A for the 21-23 March 2011 joint meeting addressing the definition of initial direct costs for the joint project on leasing. On page 4, paragraph 14 of this agenda paper, the staffs note that the definition proposed for the joint exposure draft *Leases* is not intended to change current practice for how initial direct costs are defined. ASC 840-20-25-18 permits "that portion of employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that lease…" to be included in initial direct costs of a lease. We believe the staffs' paper suggests there is no difference between IFRS and US GAAP currently, which is consistent with our observations in practice. Therefore, we believe the Interpretations Committee's tentative agenda decision as drafted would create an IFRS/US GAAP difference.

We believe the tentative agenda decision is inconsistent with the decision published in the September 2008 *IFRIC Update* on IAS 32 in which "… the IFRIC also noted that the terms 'incremental' and 'directly attributable' are used with similar but not identical meanings in many Standards and Interpretations. The IFRIC recommended that common definitions should be developed for both terms and added to the Glossary as part of the Board's annual improvements project." These definitions were not added to the Glossary and new standards are being developed that rely on these concepts, for example, the proposed new revenue and insurance standards. For standards developed jointly by the IASB and FASB, consistent definitions become more important. For example, the joint revenue standard, which is expected to be issued in Q1 2014, will not only create another standard that uses the term 'incremental costs', but also will provide a converged definition of incremental costs for the purpose of a single standard. A common definition of 'incremental costs' that would apply to all the standards that use the concept of 'incremental costs' would result in greater consistency in the application of its meaning among IFRS standards and among lessors reporting under IFRS and US GAAP.

Paragraph 38 of IAS 17 indicates that some internal costs are incremental and directly attributable to negotiating and arranging a lease: "Initial direct costs are often incurred by lessors and include amounts such as commissions, legal fees and *internal costs* (emphasis added) that are incremental and directly attributable to negotiating and arranging a lease. They exclude general overheads such as those incurred by a sales and marketing team." Some preparers consider certain internal costs as incremental or variable costs (not as fixed costs). These costs are directly related to specific activities performed by the lessor that would not have occurred but for that successfully executed lease. Those activities may include: evaluating a prospective lessee's financial condition, evaluating and recording security arrangements, negotiating lease terms, preparing and processing lease documents and closing the lease transaction. These activities are initiated upon the prospective lessee's desire to enter into a lease, on behalf of the lessor and they relate directly to entering into the successfully executed lease. Therefore, they are integral to leasing. These companies typically have a time-tracking system in place to allocate time (and costs) to a specific lease arrangement and capitalise certain internal costs that relate to successful leases.

In its tentative agenda decision, the Interpretations Committee noted that "… internal fixed costs do not qualify as 'incremental costs'. Only costs that would not have been incurred if the entity had not negotiated and arranged a lease should be included in the initial measurement of a finance lease receivable" and "… in the light of the existing IFRS requirements, neither an Interpretation nor an amendment to IFRSs was necessary." However, the Interpretations Committee does not indicate where in existing IFRS it is stated that internal fixed costs do not qualify as 'incremental costs' and, in turn, how this reconciles to the language in paragraph 38 of IAS 17, quoted above. Therefore, it is not clear why the Interpretations Committee concluded that the issue is clear in IFRS. It appears the Interpretations Committee may have reached such conclusion based, in part, on a perceived lack of diversity as indicating that it believes IFRS is clear on the issue when it noted that, "… there does not appear to be diversity in practice on this issue." However, we have observed diversity spanning multiple geographic areas (i.e., Australia, Europe and North America).

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Without further explanation as to why certain internal fixed costs do not qualify as 'incremental costs', it would appear that the application of the agenda decision by these companies would be treated as a correction of an error in accordance with IAS 8.

In summary, we do not agree with the Interpretations Committee's tentative agenda decision. We do not believe IAS 17 is clear that certain internal fixed costs do not qualify as incremental costs as paragraph 38 clearly indicates that some internal costs are incremental and directly attributable to negotiating and arranging a lease. Clarification is needed to provide guidance on what costs the Board had in mind, as we believe a reasonable interpretation of paragraph 38 is that capitalising certain internal costs would be appropriate. In addition, the IASB has not acted upon the Interpretations Committee's September 2008 recommendation that common definitions of 'incremental' and 'directly attributable' be developed. Because the Interpretations Committee previously has been asked to clarify the definition of 'incremental', we recommend that the Interpretations Committee add the issue to its agenda. However, if the Interpretations Committee decides to uphold its November 2013 tentative agenda decision, we recommend that it clarify why it made its decision and how the application of that decision should be treated under IAS 8.

Should you wish to discuss the contents of this letter with us, please contact Leo van der Tas at the above address or on +44 (0)20 7951 3152.

Yours faithfully

Ernst + Young Global Limited

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

June 27, 2014

Chairman Russell Golden
Financial Accounting Standards Board
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P.O. Box 5116
Norwalk, Connecticut 06856-5116

Chairman Hans Hoogervorst
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Subject: Lease Accounting Project, Lessee Accounting

Dear Sirs:

The National Association of Real Estate Investment Trusts (NAREIT®) is submitting this unsolicited comment letter to provide the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB, and collectively, the Boards) its views on the relative financial reporting impacts of accounting for Type A and Type B leases. We recognize that there are a number of constituents that believe that the income statement impact of these two approaches to accounting for leases results in only minimal differences in charges to net income of lessees. We do not agree with this assessment and wish to provide the Boards our views with respect to broader considerations regarding the differences between Type A and Type B lease accounting and financial reporting. These considerations include conceptual differences between lease types and the usefulness to investors and other financial statement users of reported information.

Based on these broader considerations, as well as the quantitative differences between the proposed Type A and Type B accounting, NAREIT agrees with the FASB's view that a dual approach to accounting for leases is necessary in order to provide investors and other financial statement users with the most relevant information with respect to leases.

We support the Boards' decision to continue the reconsideration of accounting for leases, and we agree that lessees should reflect an asset and a liability for substantially all leases. We also continue to support the global convergence of a high quality set of financial reporting standards.

Conceptual Considerations

We agree with the FASB's decision to adopt Type B accounting for leases that do not transfer control over the asset to the lessee and that the criteria in International

Accounting Standard (IAS) 17 *Leases* should be used in making that distinction. Because IAS 17 is well understood by financial statement preparers that currently report under IFRS, as well as auditors and regulators, we do not believe the dual model approach would increase complexity in applying the standard. Those leases that transfer control over substantially all of the future economic benefits of an asset to the lessee would be classified as a Type A lease and accounted for effectively as a purchase. Leases that do not transfer substantially all of the future economic benefits of the leased asset would be accounted for as Type B leases.

We also believe that the IASB's reference to the lessee model as a "single model" is a misnomer. The IASB has previously agreed to a scope exception for "short term" leases, as well as a practicability exception for "small ticket" leases. In our view, this amounts to a lessee accounting model that has three alternatives. In essence, the IASB is trading existing IFRS (*i.e.*, finance leases and operating leases) for a new model that will now have three types of leases: finance-type leases (*i.e.*, Type A leases), "short term" leases, and "small ticket" leases. We fail to see the simplification that the IASB's current decisions would provide over existing IFRS.

For Type B leases, there is clearly a linkage between the rights to use the asset and the lessee's obligation to make payments under the lease. Considering this linkage, we believe that the lessee should allocate the total cost of the lease over the term of the lease. We believe that the Type B accounting approach adopted by the FASB recognizes the linkage between the rights to use the asset and the lessee's obligation to make payments under the lease and more appropriately accounts for the economic differences between arrangements that simply provide a right to use an asset and those that are in-substance purchases of assets.

Quantitative Considerations

As indicated above, we understand that certain constituents are of the view that the income statement impacts of the two approaches to accounting for leases results in only minimal differences in charges to net income of lessees. Our experience indicates that this may generally not be the case. For example, a large global retailer developed pro forma financial impacts on the company's 2013 operating results that would result from applying the accelerated expense recognition patterns consistent with the proposed Type A accounting approach to all of the company's leases. The resulting pro forma net income was $46 million, $0.16 per share, less than net income reported for 2013. Applying the company's multiple to the $0.16 decrease in net income would negatively impact the company's stock price by $2-3 or about 10%.

Simply put, we do not consider this 10% negative impact to be "minimal."

In addition to the negative impact on earnings of applying the Type A approach to all leases, we agree with the analyses and conclusions reached with respect to the impacts on the balance sheets of a number of large global companies described in the June 25, 2014 unsolicited comment letter submitted to the Boards by the Equipment Leasing and Finance Association[1].

[1]http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175828960081&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content Disposition&blobheadervalue2=831047&blobheadervalue1=filename%3DLEASES-14.UNS.0009.ELFA_WILLIAM_G._SUTTON.pdf&blobcol=urldata&blobtable=MungoBlobs

Usefulness of Reported Financial Information

The Boards have consistently indicated that financial standards should primarily serve the needs of investors and other financial statement users. NAREIT strongly agrees with this principle and believes that the presentation of financial information must provide relevant information to financial statement users. If information is not relevant, there is no need to debate the conceptual merits of the accounting.

An important standing committee of NAREIT is its Best Financial Practices Council. This Council reviews all financial reporting proposals that may impact the real estate industry's financial reporting, including proposals from the FASB, IASB and Securities and Exchange Commission (SEC). The Council currently includes 27 members representing a broad cross section of NAREIT's membership, including six investors/sell-side analysts. These financial statement users (and other investors and analysts who are NAREIT members) have been very clear in their position that, to be relevant, payments made by lessees pursuant to a lease of property should be reported as rent expense and not bifurcated as interest and amortization. Further, investors/sell-side analysts on the Council have consistently stated that, should the new Leases standard result in the elimination of rent expense, they would then ask companies to assist them in unwinding the proposed accounting. This would lead to analysts making capital allocation decisions based on unaudited/non-GAAP financial information, which in our view would not provide users with the most reliable decision-useful information.

If you would like to discuss our comments, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at 202-739-9432 or gyungmann@nareit.com, or Christopher Drula, NAREIT's Vice President, Financial Standards, at 202-739-9442 or cdrula@nareit.com.

Respectfully submitted,

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